U.S. TRADE DEFICIT

HEARINGS

BEFORE THE

SUBCOMMITTEE ON TRADE

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-EIGHTH CONGRESS

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U.S. TRADE DEFICIT

WEDNESDAY, MARCH 28, 1984

House of Representatives,
Committee on Ways and Means,
Subcommittee on Trade,
Washington, DC.

The subcommittee met at 9:50 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Sam M. Gibbons (chairman of the subcommittee) presiding.

[Press releases announcing the hearings follow:]

[Press release of Monday, Feb. 27, 1984]

HON. SAM M. GIBBONS (D., FLA.), CHAIRMAN, SUBCOMMITTEE ON TRADE, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES HEARINGS ON THE U.S. TRADE DEFICIT

The Honorable Sam M. Gibbons (D., Fla.), Chairman of the Subcommittee on Trade of the Committee on Ways and Means, U.S. House of Representatives, today announced hearings to examine the growing U.S. trade deficit. The hearings will focus on the underlying causes of the deficit and will assess the implications of this imbalance for U.S. trade and economic policy. The hearings will also address what measures may be necessary to reduce the deficit. In the first phase of hearings, testimony will be received from the U.S. Trade Representatives, the Department of Commerce, the President's Council of Economic Advisers, the Department of Treasury, the Federal Reserve Board, the Export-Import Bank, the International Monetary Fund, the World Bank, and leading Members of Congress. In the second phase, the Subcommittee will hear from the leaders of U.S. industry and labor, the banking and financial sector, and leading private economists. The hearings will begin in late March. Actual dates for the Subcommittee hearings and a list of witnesses for the first phase of the hearings will be announced in a subsequent release.

The deficit in U.S. merchandise trade for 1983 was $69 billion, an increase of nearly $30 billion over the 1982 level. Projections for 1984 range as high as $120 billion. These record deficits are prompting a growing number of requests from major U.S. industries for import relief and other forms of government support. While the Subcommittee has recently sought to address many of the problems confronting the United States in its international trade—such as the need for greater discipline over unfair subsidies and dumping, and the need to improve access to foreign markets for U.S. exports—it is increasingly obvious that larger economic factors are also among the major causes of our negative balance of trade. The purpose of the hearing will be to consider how the Nation's overall economic policies can better address this serious threat to our international competitiveness.

Among the issues to be raised during these hearings will be:

Factors causing the overhauled dollar, and its effect on U.S. competitiveness. The President's own Economic Report states that the real appreciation of the dollar between 1980 and 1983 was 45 percent. Witnesses will be asked to present evidence and draw conclusions regarding the causes and effects of the high dollar, as well as the policy alternatives which may exist to bring about a more favorable exchange rate.

The relationship between our merchandise trade deficit and our overall balance of payments. In recent years the impact of our merchandise trade deficit has been mitigated somewhat by a surplus in services trade and U.S. foreign investment earnings. However, these relationships are rapidly changing and the U.S. current account has now slipped into substantial deficit.

The effect of the Third-World debt problem on U.S. trade. The President's report points to the enormous drop in our exports to debtor nations—$21 billion in reduced exports to Latin America alone—as a result of their liquidity crisis. Since many countries have reduced their imports and expanded exports in response to the IMF's lending policies, trade experts are becoming increasingly concerned about the clash between international trade rules and international lending policies.

Those sectors of the U.S. economy most affected by increased imports or lower exports and the long-term consequences for these industries. Statistics indicate that certain sectors—agriculture, machinery and equipment, textiles, and consumer goods—have experienced disproportionate changes in their competitive position.

The probable consequences of implementing various measures to reduce the deficit. Among the alternatives frequently discussed are: tariff and quota measures; import surcharges; foreign exchange intervention; a more expansionary monetary policy; capital controls; industrial policy measures; and changes in fiscal policy.

In announcing the hearings, Chairman Gibbons said:

"The Subcommittee on Trade has recently conducted an intensive examination of U.S. trade law and its adequacy to deal with problems confronting American businesses around the world. During our deliberations, however, it has become obvious that any efforts to improve U.S. competitiveness and level the playing field for world trade are being offset by conditions beyond the reach of traditional trade policy. A complex set of interrelated factors—the budget deficit, high interest rates, an overvalued dollar, and mounting foreign debt—have combined to erode U.S. competitiveness. We now have a trade deficit with virtually every major trading bloc.

"It is understandable that such conditions would create a climate for increased protectionism. In the coming months, Congress will be faced with numerous proposals for quotas or higher tariffs. I believe it is essential to gain a better understanding of the broader economic conditions now affecting the U.S. trade balance before we consider remedies. I hope that our hearings will serve to clarify the problem and thereby lead us to wise and effective solutions."

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

Requests to be heard must be made by telephone to Harriett Lawler [telephone (202) 225-3627] by close of business, Wednesday, March 20, 1984. The request should be followed by a formal written request addressed to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Room 1102 Longworth House Office Building, Washington, D.C. 20515.

In view of the limited time available to hear witnesses, the Subcommittee will not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance will be encouraged to submit written statements for the record of the hearing. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

It is urged that persons and organizations having a common position make every effort to designate one spokesman to represent them in order for the Subcommittee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearing. This process afford more time for Members to question witnesses. In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

In order to assure the most productive use of the limited amount of time available for questions, witnesses appearing before the Subcommittee are required to submit 200 copies of their prepared statements to the full Committee office, Room 1102, Longworth House Office Building, at least 24 hours in advance of their scheduled appearance.

Requests to be heard must contain the following information:

1. The name, full address, and capacity in which the witness will appear, as well as a telephone number where he or his designated representative may be reached;
2. A list of any clients or persons, or any organization for whom the witness appears; and
3. A topical outline or summary of the comments and recommendations in the full statement.

The above information should also be incorporated in the prepared statements to be presented in person as well as those filed for the printed record of the hearing.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

Persons submitting a written statement in lieu of a personal appearance should submit at least six (6) copies of their statement, by the close of business Tuesday, April 24, 1984, to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Room 1102, Longworth House Office Building, Washington, DC 20515. If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Committee office before the hearing begins.

[Press release of Friday, Mar. 16, 1984]

HON. SAM M. GIBBONS (D., FLA.), CHAIRMAN, SUBCOMMITTEE ON TRADE, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES SCHEDULE AND WITNESSES FOR HEARINGS ON THE U.S. TRADE DEFICIT

The Honorable Sam M. Gibbons (D., Fla.), Chairman of the Subcommittee on Trade of the Committee on Ways and Means, U.S. House of Representatives, today announced the schedule for the first phase of hearings on the U.S. trade deficit previously announced in Subcommittee press release No. 28. The hearings will be held on March 28 and 29, 1984, in the main Committee hearing room, 1100 Longworth House Office Building. The schedule for both days will be as follows:

March 28, 1984:

9:30 a.m.—The Honorable William E. Brock, U.S. Trade Representative.

11:30 a.m.—The Honorable William H. Draper III, President and Chairman, Export-Import Bank of the United States.

March 29, 1984:

9:00 a.m.—The Honorable Martin Feldstein, Chairman, President's Council of Economic Advisers.

11:00 a.m.—The Honorable Beryl Sprinkel, Under Secretary for Monetary Affairs, Department of the Treasury.

2:00 p.m.—The Honorable Malcolm Baldrige, Secretary of Commerce.

The Honorable Paul A. Volcker, Chairman of the Federal Reserve System, is tentatively scheduled to appear before the Subcommittee on April 10, 1984. Details regarding Mr. Volcker's appearance, as well as a schedule of private sector witnesses for the second phase of the hearings, will be announced shortly. The private sector phase is tentatively scheduled to begin in early April.

[Press release of Wednesday, Apr. 4, 1984]

HON. SAM M. GIBBONS (D., FLA.), CHAIRMAN, SUBCOMMITTEE ON TRADE, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES SCHEDULE FOR PRIVATE SECTOR PHASE OF HEARINGS ON THE U.S. TRADE DEFICIT

The Honorable Sam M. Gibbons (D., Fla.), Chairman of the Subcommittee on Trade of the Committee on Ways and Means, U.S. House of Representatives, today announced the continuation of hearings on the U.S. trade deficit previously announced in Subcommittee press releases No. 28 and No. 30. The hearings will be held on April 5, 10, and 12, 1984, in the main Committee hearing room, 1100 Longworth House Office Building. The schedule for April 5 will be as follows:

April 5, 1984:

9:30 a.m.—Panel—

Lee M. Morgan, Chairman, Caterpillar Tractor Company; Chairman, Business Roundtable Task Force on Trade and Investment; Member, Emergency Committee for American Trade;

Edwin Spencer, Chairman, Honeywell Corporation; Member, Business Roundtable Task Force on Trade and Investment; Member, Emergency Committee for American Trade;

Robert Kilpatrick, Chairman, CIGNA Corporation; Chairman, Business Roundtable Budget Task Force; and

John Nevin, Chairman, Firestone Tire and Rubber; Member, Business Roundtable Task Force on Trade and Investment.

11:30 a.m.—Panel—

Robert D. Hormats, Vice President Corporate Finance International, Goldman, Sachs; and

C. Fred Bergsten, Director, Institute for International Economics.

1:00 p.m.—Panel—

Robert Solomon, Guest Scholar, Brookings Institution; and

Paul Craig Roberts, The William E. Simon Fellow in Political Economy; Center for Strategic and International Studies of Georgetown University.

Details regarding the remainder of the schedule of private sector witnesses will be announced shortly.

[Press release of Friday, Apr. 6, 1984]

HON. SAM M. GIBBONS (D., FLA.), CHAIRMAN, SUBCOMMITTEE ON TRADE, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES SCHEDULE FOR CONTINUATION OF PRIVATE SECTOR PHASE OF HEARINGS ON THE U.S. TRADE DEFICIT

The Honorable Sam M. Gibbons (D., Fla.), Chairman of the Subcommittee on Trade of the Committee on Ways and Means, U.S. House of Representatives, today announced the continuation of hearings on the U.S. trade deficit previously announced in Subcommittee press releases No. 28, and No. 30, and No. 32. These hearings are addressing the causes of the large trade deficit and the implications of the imbalance for U.S. trade and economic policies. The hearings also are exploring what measures, if any, may be necessary to reduce the deficit. The hearings will be held on Tuesday, April 10, 1984, in room 1100, Longworth House Office Building, the Committee's main hearing room, and on Thursday, April 12, 1984, in a room to be announced.

The featured witness on April 10 will be the Honorable Paul A.Volcker, Chairman, Board of Governors of the Federal Reserve System, who will appear at 9:30 a.m. The full schedule for April 10 and 12 will be as follows:

April 10, 1984:

9:30 a.m.—The Honorable Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System.

11:30 a.m.—Panel—

Richard S. Peterson, Senior Vice President and Economist, Continental Illinois Bank and Trust Company of Chicago; and

H. Robert Heller, Vice President for International Economics, Bank of America.

1:00 p.m.—Panel—

American Federation of Labor and Congress of Industrial Organizations: Rudy Oswald, Director, Department of Economic Research; and

International Union, United Automobile, Aerospace and Agricultural Implement Workers of Amercia, UAW: Lee Price, International Economist.

April 12, 1984:

9:30 a.m.—Panel—

National Association of Manufacturers: Lawrence A. Fox, Vice President and Manager, International Economic Affairs;

Motor and Equipment Manufacturers Association (MEMA): Ron Herman, Vice President, MEMA; and President, General Automotive Speciality Co. Inc.;

National Foreign Trade Council: Richard W. Roberts, President;

American Express Company: Harry L. Freeman, Senior Vice President, Corporate Affairs and Communications;

American Fiber, Textile, and Apparel Coalition: Sol C. Chaikin, President, International Ladies' Garment Workers' Union, AFL-CIO; and

Donald W. Bedell, Management Consultant, Bedell Associates.

Chairman GIBBONS. Good morning, ladies and gentlemen.

This is the day we begin subcommittee hearings to examine the growing U.S. trade deficit. The hearings are intended to focus on the underlying causes of the deficit and to assess the implication of the imbalance for U.S. trade and economic policy.

One need only look at the figures to realize what a major concern this is to us. The U.S. trade deficit has grown from $13 billion in 1976 to $69 billion in 1983. That is, of course, the merchandise trade deficit. It is projected to grow to over $100 billion this year. Here again, we are still talking about the merchandise trade deficit. In addition, our current account balance has gone from a surplus in 1981 to a deficit of over $40 billion last year.

The purpose of this hearing is to analyze where we are, how we got there, and where we are going from here. This is an enormously complex subject, involving a set of interrelated factors—the budget deficit, high interest rates, an overvalued dollar, and mounting foreign debt. All of these factors have combined to erode U.S. competitiveness.

In fact, we now have a trade deficit with virtually every major trading bloc in the world. Moreover, the United States is quickly becoming a debtor nation, as we pull in more and more foreign investments to offset these deficits and to finance our spiraling budget deficit. A better understanding of what these changes mean to the future of America is of critical importance.

Today the subcommittee will be hearing testimony from administration witnesses, including Ambassador Brock and the head of the Export-Import Bank, Mr. William Draper. Tomorrow the Chairman of the President's Council of Economic Advisers, Mr. Martin Feldstein, will be our leadoff witness at 9 a.m. Thereafter, we will be hearing from Mr. Beryl Sprinkel, the Under Secretary of the Treasury for Monetary Affairs. Tomorrow afternoon we will hear from the Secretary of Commerce, Mr. Malcolm Baldrige.

The private sector begins April 5 and will include the chief executive officers from major U.S. companies, leading bankers, international economists, representatives of organized labor, and other trade associations. We will also have the Honorable Paul Volcker, the Chairman of the Federal Reserve System, who will appear on April 10 at 9:30 a.m.

The Trade Subcommittee staff has prepared a number of charts which can be displayed and referred to by members and by witnesses during the course of the hearing. Each member has a copy of these charts and their explanatory material.

I wonder if any of my colleagues would like to make any statements or observations before we hear Ambassador Brock? Does anyone have any statement they would like to make?

Mr. SCHULZE. Mr. Chairman.

Chairman GIBBONS. Mr. Schulze.

Mr. SCHULZE. Just an observation. We read almost daily in newspapers, magazines, periodicals, and daily on television we hear about our trade imbalance. It does have important ramifications not only for our domestic economy, but it also reverberates around the world, and I would hope that the information gathered at these hearings can be put to good use.

It is of great concern, and we hope to be enlightened and have a beneficial result from these hearings, and you are to be congratulated for holding them.

Chairman GIBBONS. Thank you, Mr. Schulze.

May I say to my colleagues, if any of you have any witnesses you would like to suggest or like to have invited, we would be happy to do so. And I might also point out that we have invited the Members of Congress who would be interested to come in and express their opinion about the subject.

I want these hearings to be full and thorough and, while we will use the 5-minute rule the first time around in questioning, if members have further questions I purposely have scheduled the witnesses so that we are not in a big rush to get them all done, and I want members to be thoroughly satisfied that they have not only exhausted their full bag of questions but that the witnesses also respond to it.

I regret that we have to appear so formal, with Mr. Brock sitting way over there and us sitting way up here, but I want the atmosphere to prevail that we are here to discuss this and try to get at the ultimate facts: What has caused our trade deficit, where are we in this whole picture, and where do we go from here.

Ambassador Brock.

STATEMENT OF HON. WILLIAM E. BROCK, U.S. TRADE REPRESENTATIVE

Ambassador **Brock**. Thank you, Mr. Chairman.

I spent certainly the last 20 years looking up to this committee and I have no problem continuing to do that. [Laughter.]

Chairman **Gibbons**. I would much rather be on a level playing field with you. [Laughter.]

Ambassador **Brock**. I started to say I brought my umbrella with me inside, but I think we can dispose of that.

Let me treat this hearing in the sense that you just mentioned, very informally, and try to sketch out some points. I will submit a complete statement for the record, Mr. Chairman, but I really think this issue is sufficiently complicated that we would be better served by a discussion.

Chairman **Gibbons**. Well, would you just like to go ahead and let members interrupt you as you go? I will try to be a pretty impartial referee. I hate to make that kind of promise in advance, because I am never sure where I will end up. But go right ahead.

Ambassador **Brock**. All right.

Chairman **Gibbons**. Why do we not let you proceed for 5 or 10 minutes, and then if members want to interrupt and ask questions as they come to mind, let's go ahead and do that. Let's try it that way.

Ambassador **Brock**. That is perfect. Let me just lay out what I think are the three largest and most fundamental causes underlying our current deficit and give you a brief discussion of each of them.

First, there is just no question about the impact our own economic recovery has done on trade. We have recovered far faster than any other nation in the world from the most deeply rooted recession the world has experienced—and it was a global recession—since the 1930's.

As a consequence of that recovery here, we have been almost like a dry sponge. We have simply sopped up imports from around the world very rapidly, while at the very same time our export opportunities have been severely limited by the absence of that recovery in most other parts of the world.

Complicating that has been the international debt crisis. We had in the 1970's we had not for us but for most of the world, three energy crises. We had two energy shocks, but the rest of the world had three: The first one, the embargo crisis of 1973–74; the second one was the Irani and Iraqi war.

But then they got hit by a third shock, which was the explosion in the value of the dollar. The change from 1978 to 1980, 1982, and 1983 put a third burden on the developing countries particularly.

Now, when you complicate that with an explosion in interest rates and the world recession and a collapse of commodity prices, almost everything that could happen bad did happen to those countries. The debt grew to somewhere between $650 and $800 billion. To service that debt these countries had to cut their imports by as much as 40 percent. And this obviously has its greatest impact in Latin America, which was a primary market for U.S. exports.

Now, I would point out to you that between 1981 and 1983 our trade deficit or trade balance with the eight high-debt Latin countries deteriorated by $20 billion, from a surplus of $5.8 billion to a deficit of $14 billion, and that is two-thirds of the depreciation in the trade account that occurred.

Chairman GIBBONS. Would you go over that again?

Ambassador BROCK. In 1981 we had a $5.8 billion surplus with the eight largest Latin American debtor countries. In 1983 we had a $14 billion deficit. Now, that was very obviously a consequence of their actions to try to meet their debt payments. To acquire the foreign exchange to do that, they had to subsidize their exports, to promote their exports and to almost stop across the board their imports.

Obviously, that kicked us right in the teeth, because we are the prime supplier for a number of those countries. It is awfully important for us to understand that when two-thirds of the deterioration in trade occurs in that one market area, our stake in their recovery is very sizable. So if we are going to have a recovery in our export performance, it is very important that they have a recovery in their own export economy.

Now, we will get into that later, but I did want to stress the importance of that issue.

Chairman GIBBONS. That is for Central and South America alone?

Ambassador BROCK. Yes; just for Central and South America, and primarily the debtor countries in that regions. Not all of the countries are included in those numbers. And frankly, that is why we are asking for an extension of the generalized system of preferences [GSP] program, Mr. Chairman.

The third area that I wanted to mention among the causative factors in our current trade deficit is the value of the dollar. Since 1980 or the late seventies, the dollar has risen about 40 percent in relative terms to the basket of all other countries, and in some cases it has risen a good deal more than that. In contrast with the French franc, for example, the dollar has risen almost 80 percent.

Mr. PEASE. Over what period of time?

Ambassador BROCK. That is in about a 4-year period.

The genesis of that shift in currency valuation is fairly complex. We have had a very sizable movement of capital into the United States. When people buy investments here, they are buying dollars and that pushes the price of the dollar up.

That is not an illogical consequence of our recovery. We are doing better. The U.S. stock market is booming, and our interest rates are higher in real terms than anybody else's. We are a logical place for investment.

I would caution you against thinking that all of that money is coming from debtor countries like Brazil or from politically troubled economies such as Central America. This money is coming from every country in the world. Last year we had for some time a flow from Japan running about $2.5 billion a month. It is a global phenomenon and not simply a crisis phenomenon.

The crisis has contributed to it, the fact that we are the world's reserve currency has contributed to it, the fact that we are a safe harbor for world investment, we are the most stable, prosperous, best place to invest—all of those are part of the reasons. And I would hope that none of us want to change any of those factors.

The fact that we are more stable and prosperous is a remarkable blessing for us, but that does lead to the question of what element of this equation can we deal with? We certainly do not want to be unstable. We certainly do not want to abort the recovery. This brings us to the one element where we can have an impact, and that is in the interest rate area.

If you look at our interest rates, we borrowed abroad $40 billion last year and the projections are—and I think the chart over here, shows it—that we will borrow somewhere in the area of $80 billion abroad this year.

Now, gentlemen, the hazard of all of that is I think pretty obvious. We are dependent on the acquisition of foreign capital to sustain investment and ultimately in the recovery here. That is a dependency that is somewhat hazardous.

The only other element of surplus in our capital formation in the currency market in this country at the moment is the surplus—or are the surpluses being created at the State and local government level. But if you take the savings of the American people, they pretty well wash out against the Federal deficit.

And that leaves us with two sources above the savings, private and corporate, of Americans: State and local government surpluses and foreign capital acquisition. The hazard that I would suggest to you we face is fairly serious in the sense that if, for whatever reason, there became more risk in investing in the United States, if our economy became a little bit tremulous and that investment began to dry up, in order to continue to borrow that money, because we have to have it—there is a demand here and it is very sizable, we are going to push these interest rates up very fast.

That is a risk that I suggest is not in our national interest, nor is it in our trading interest. I think it is already true that other countries feel that we are draining their recovery capacity at this point by pulling the $40 billion out of their economy in the last year and the prospective $80 billion this year.

Now, let me make one point in a different area. I am troubled by the discussion of the trade deficit as if it were a reflection of a fundamental deterioration in the competitiveness of American business generally. There simply is no evidence whatsoever that that is true.

As in most cases in the world, there are industries that are doing very well, there are industries that are doing very poorly. You run the whole spectrum of economic performance in an economy as broad and diverse and deep as this one is.

But in general terms, since 1970 industrial production in the United States has surpassed that of Canada, Germany, France, Britain, the Netherlands, and a whole range of other countries. It has grown by 41 percent in the last 12 or 13 years.

Whatever the impact of domestic determinants of our competitive situation, such as innovation, investment, and productivity, they have not led to U.S. disindustrialization, nor do they account for the sharp recent increase in the U.S. trade deficit.

Chairman GIBBONS. Mr. Ambassador, I want you to go back and reemphasize your position there, because, having looked over some of the future testimony of witnesses, I know there are going to be some people that dispute that. So could you make the point that you just finished making again and elaborate on it to the extent that you want to.

Ambassador BROCK. By almost any measure that I have seen in the last 20 years of relative economic performance, the United States is the most competitive, productive country in the free world, or in the world, period, by a factor of some magnitude.

Chairman GIBBONS. That includes Japan?

Ambassador BROCK. That includes Japan, absolutely. In terms of the productivity of the American people across the span of all of our economic activities, we are considerably more productive as a people than the Japanese or any other society with which I am familiar.

If you look at the growth in terms of our more traditional competitors in Europe, as I point out, we have exceeded the record of our competitors in all of those areas—Canada, Germany, France, Britain, the Netherlands, and so on. We have had an increase in production of 41 percent.

Now, what has happened, Mr. Chairman, is that we have done that in the face of some pretty tough circumstances. We endured two major energy crises in the 1970's. We endured the advent of women into the work force in numbers that we had never seen before, which was a fabulous contribution but also a difficult burden to absorb in a short period of time.

We absorbed 12 million—12 million—legal and illegal immigrants in the 1970's. We had the baby boom to absorb. We did all of that.

We created in that period of time somewhere between 19 and 20 million net new jobs, not many of which went into the Fortune 500. These new entrants went into a variety of jobs in this economy, at the same time that Europe was creating no new jobs, no net new jobs in the 1970's.

Our performance in this country has been absolutely spectacular in any relative sense whatsoever. And there is, again to repeat, no evidence of across-the-board deterioration in our competitive circumstance.

There is substantial evidence that some of our industries have gotten out of competitive whack. Otherwise we would not be talking about automobiles. But I think you can put that down to some factors that were of their own making and some not.

Nobody can accuse the UAW and GM of starting the Irani-Iraqi War, but the fact is that when that war started there were 300,000 unsold Japanese cars in inventory in the United States, and they were not selling well. The day those gas lines formed and we were producing large cars, and it takes us 3 to 5 years to change our production in any significant sense, we started getting into economic difficulty.

Mr. JENKINS. Mr. Ambassador, if I could stop you right there.

Ambassador BROCK. Sure.

Mr. JENKINS. You are making a statement about what has happened in the last 12 to 15 years in increased production. How do the figures in the last 3 or 4 years compare? Are we static or what?

Ambassador BROCK. In terms of industrial competitiveness, we are more productive than any other country, but the gap has narrowed somewhat, particularly with regard to Japan. The study that I saw was about 1½ years old in this particular area and at that time, using Japan as a base of 100, we were at 107 in terms of industrial productivity.

If you add services and agriculture and the other areas of our economic activity, we are substantially higher than that, going to 165 on that scale, in a couple of years.

Mr. JENKINS. I was under the impression that in the last 3 or 4 years we had taken somewhat of a dive as compared to the last 15 years.

Ambassador BROCK. Well, you see, everybody else took a dive at the same time. This recession has been global, and we did suffer, but everybody else was suffering in like fashion. I do not think in relative terms you have seen that much of a shift.

Where we have the problem, Congressman—and this has been a factor of the last 4 years, as Congressman Pease noted—is in the value of the dollar, where we went from an extremely, extremely low value in 1979 to just an incredibly high value in 1983.

That shift in that short a period of time—and 4 years is a long period of time, because your investment decisions are made 5 and 10 years out—has really caused a lot of agony.

But that is not a change in our fundamental economic posture. It is a change in currency over which business and labor have no control at all.

Mr. PEASE. Would the gentleman yield?

Mr. JENKINS. Yes.

Mr. PEASE. I would like to pick up at this point also. You said that GM and the UAW couldn't be blamed for starting the Irani-Iraqi War, and that is certainly true. And it is heating up again, as you know. We could be back in the soup again in oil supplies from the Middle East.

What happened in the Irani-Iraqi War was Americans all of a sudden became very sensitive to high mileage cars and the demand increased dramatically for the kinds of cars that the Japanese make and the Germans and the French and so on. But it appears now that the U.S. auto industry is on the verge of giving up production of small cars.

Lee Iacocca says that if this GM-Toyota merger goes through, he is going to have no choice but to follow suit and Ford will do the same. We see small cars being produced in Japan, Korea, Mexico, outside of the United States, and it appears to me that what is happening is that the auto industry is positioning itself to make medium-sized cars and larger cars, and to give up making smaller cars

What happens if we have another Iran-Iraq War and the price goes up again of oil or gasoline and people become sensitive again? Then the demand is going to be in a sector where we do not even have a manufacturing capacity, which would certainly further increase the deficit in terms of automobile imports.

As you know, the domestic content bill would deal, however perfectly or imperfectly, with that situation. The administration has opposed it. The administration seems to favor this Toyota-GM merger or joint venture out in California.

Does the administration agree that we have a problem as I have described, or a potential problem? And if so, does it have any suggestions on how we go about dealing with it?

Ambassador **Brock**. I think, first of all, yes, we have a problem. And second, it is not very different from the problem that existed in 1979. When the Irani and Iraqi War broke out, we did not have the production capacity then. I think you could expect if we had a shortage of supply of similar magnitude that you would have a similar response.

That is exactly what happened in 1979, 1980, and 1981. We had a surge of imports, because we did not have the capacity to produce that car.

Do we have an answer? I do not think there is a very simple governmental response.

You say that the industry is preparing us with the statements that they are going to have to source out for a change. I think they could also be preparing us for a request for more protection, and I wonder if that is really the answer.

The reason that we appreciated the action of Japan in putting restraints on the export of automobiles in 1981, for the last 3 years now, going on for another year into 1985, was that it was supposed to give us time to move our production into a broader range, more comprehensive and more efficient range, and to improve our quality so that we could compete.

I think the industry and the unions have done a remarkably good job of adapting in a fairly short period of time. But I have to admit a considerable amount of trouble as I perceive their actions at the moment. I have seen, I think it was a report in the press, that there was 180 million dollars' worth of bonuses going to GM executives this year. I see where the head of the UAW has asked for a get-back of all the give-backs and more.

The reason that we have the highest profits in history in the industry this year and a very high surge in sales is in part due to the restraint on the part of the Japanese. That is a false market, and I wonder if it is really logical for us to think that the problem is solved when in fact we are living in an unreal world. Is it logical for us to continue to protect an industry under these circumstances? I think that is a fair question for the rest of us as consumers to ask.

Now, what is the difference between continuing the protection or extending it or adding to it in the form of some voluntary quota, which is a euphemism for a trade barrier? What is the difference between that and domestic content? They both are hiding from the competitive juices of the marketplace.

Mr. PEASE. I think I see your answer in your question. Apparently you are disturbed by what the American auto industry is doing and the direction it is moving in, and you are not inclined to have any program at all to help out or to redirect or cause them to change their self-destructive path.

Ambassador BROCK. Well, I guess I am of a mood to help people who want to help themselves, Congressman. And I would like to see a little evidence of that some time.

Mr. PEASE. Have you expressed those sentiments directly to auto company executives and to the UAW?

Ambassador BROCK. On a few occasions, yes.

Mr. PEASE. One other aspect, if I may, while we are talking about cars. I want to get into an area that Mr. Jenkins is especially interested in, although not enough, I hope, to cause him any alarm.

Last year we had a sizable trade deficit in textiles and apparels, approaching $10 billion, and the administration committed itself to keeping the growth of our textile and apparel imports within the rate of growth of our domestic market, which would keep the import share constant. I believe on that basis you renegotiated our MFA agreements with many countries last year because their imports were rising faster than the market.

However, against that $10 billion trade deficit in apparel, we had a $24 billion deficit last year in automobiles and auto parts, up from $12 billion only 2 years before in 1981. Thus, in 2 years we had a bigger increase in our auto deficit than the total deficit in textiles and apparels.

We talk a lot about Japan as being a problem, and yet of that $24 billion deficit only about $11 billion I understand is really from Japan. A lot of the rest of it comes from Europe.

Is there some lack of symmetry here between the administration's concern for the apparel and textile industry and not allowing imports to grow faster than the market there and the apparent laissez-faire attitude toward the auto industry.

Chairman GIBBONS. Before he answers that, could I try to ask a question?

The deficit in auto trade, are you counting the Canadian autos as being imports? It is my hazy feeling that most of that deficit stems from the fact that the Canadians produce the kind of American cars that have been selling well in the American market, as I understand, and we have that two-way free trade zone with the Canadians in cars. I just wondered if your figures included the Canadian cars. I imagine they do.

Mr. PEASE. Yes, they do, although of the $24 billion, a relatively small amount has to be from Canada given that $11 billion is from Japan and we have France and Germany and other countries as well.

Ambassador BROCK. Congressman, I will respond to your real question, but I think, I believe that the figures are for a much more sizeable contribution from the Japanese. The last number I saw had Japanese imports at something between 20 and 21 percent of the U.S. market and total import penetration around 26 to 27, so that it really is impossible for Japan to only have $11 billion deficit.

Mr. PEASE. Part of that is in auto parts, I think, which may be a factor.

Are your figures finished automobiles?

Ambassador BROCK. I was talking of automobiles, so we are comparing apples and oranges. Let me check on that and try to be more precise. But the fact is that about 75 or 80 percent of the imports are coming from Japan, and we normally, as the chairman has noted, do not consider Canada because that is a two-way relationship that in some years benefits us, some years benefits them. But it seems to wash out over a period of time so that we both have gained from it, and we really do not consider that in the normal import context.

Let me go to the basic question you asked which is a little more political. I have said not entirely facetiously on some occasions in the last couple of years that this country has never made a decision as to what its strategic or critical industries are with one exception. We made a decision probably about 20 years ago that the one exception, the one critical strategic industry that we woud protect at all costs was the textile and apparel industry in the United States. We have been protecting it for about 20 years, and for a variety of reasons. The employment is very, very high, larger than I guess any other single industry. It is very dispersed and mostly in small plants around the United States, and the wage pattern is low and the skill level of employment has been low. It is an entry level type of occupation in many cases. That is not true of some elements, but it is true of probably the majority of it, and the industry has had some form of protection since 1962 or 1963.

Congressman Jenkins probably would correct me, but I think there is a difference. I don't believe I have ever heard anybody accuse the textile or apparel industry of being way out of line with American industrial wages generally. As a matter of fact, their wages are lower than the average, if my memory serves me correctly, and I don't think anyone has accused the industry of being noncompetitive. It is one of the most intensely competitive industries in the United States. Even without imports that fact is true.

So there has been in a number of ways a qualitative difference between the two, but that simply says that the political system made a judgment 20 years ago, and the judgment was that some form of protection was warranted, and it has been afforded ever since.

Mr. PEASE. Well, in a way I am happy to hear that you do see some substantive differences between the two industries. I was afraid for a while that it was just a reflection that people like Mr. Jenkins were more effective as politicians within the Congress than people like Mr. Downey and myself. I would hate to have to come to that conclusion. [General laughter.]

Ambassador BROCK. I would never discuss relative effectiveness. I would suggest you have all been pretty effective.

Mr. JENKINS. Would the gentleman yield? If the textile industry is in such good shape because of my actions, I want you to know that I feel great sympathy for any other industry because we do not feel that we are in the best condition in the world. [General laughter.]

Mr. DOWNEY. Mr. Ambassador, may I ask you two questions first having to do with that $80 billion of capital that we anticipate coming into this country? In a way, one might make an analogy that we are hooked on foreign capital as we used to be hooked on foreign oil, and both are dangerous for obvious reasons.

Can you break out for me why you think that $80 billion is coming here? You mentioned a couple of reasons, that we are a safe and vibrant market and a good investment, for example.

How would you apportion the $80 billion? Would $40 or $50 billion be coming in because we are a safe investment, or the interest rates are high? Could you break it out?

Ambassador BROCK. I am not wise enough to answer that question. I wish I were, and I am not sure I know anybody who is. But it seems to me that a substantial element has to be the real interest differential. We pay about twice the real interest rates here that are paid in Japan, and that is a pretty sizable chunk of money to give somebody as an incentive to buy here.

Mr. DOWNEY. I think that is fair. I do not know that anybody has done it, but I mean, as long as you would say that the larger portion is the interest rate, it would seem to me that that is probably a pretty wise guess of why they are here.

I would just like to ask you a couple of questions about the steel industry. The steel industry executives have visited me and other members of the committee, and they are concerned, and I share their concern, about the penetration of this market by steel that they believe is being produced as a function of social policy in some other countries. They argue, persuasively I believe, that there is no free market.

Now, there is lots of specialty steel and rolled steel and all sorts of different types, but how do you view the fact that the steel industry has fallen on hard times and that they are interested in—Mr. Murtha and Mr. Gaydos have a piece of legislation that would impose a quota on steel for a certain period of time with a requirement that they use this breathing spell to recapitalize and plow money back into enhanced production.

How does the administration feel about legislation of that sort?

Ambassador BROCK. Well, we find it about as appealing as cancer. We are not enamored of quota legislation, Congressman. You understand that. I am really bothered by the temptation to constantly use numerical or volume quotas to solve any kind of problem. If you are going to do anything, I would rather use a tariff approach where the U.S. Government at least benefits economically.

But let's lay that aside and look at the fundamental merit of the case.

The steel industry in the United States is not immune to the disease of error, just like their counterparts in other parts of the world. I saw an article recently where the Japanese, who are down somewhere between 50 and 60 percent of capacity also, made the same mistake we made in the early 1970's. They assumed that the boom was going to last forever, and that the growth path was simply up all the way.

Well, it did not happen. Substitute materials came in, and they will continue to come in from now on. We have people working on ceramic engines. We have all of the duPont work in the industrial plastics which will replace gears and bumpers. Nothing is going to reverse the technological advancies we have made, nor the pressure it is going to put on our steel industry. That has nothing to do with imports at all, nothing.

The biggest pressure on our steel industry is coming from domestic change. The fact that Fords or Chevies weigh 1,000 pounds less than they did 5 years, is what is putting the heat on, and it is going to continue to. You are going to see a significant change, and that is why I think antitrust actions are consequential and important, and indeed, steps here in the Congress are indeed important.

But import quotas are the wrong answer to the wrong problem. If you want to look at the complaint the industry makes, there are real solid grounds for complaint on the industry's part. There are subsidized products coming in here. But what I ask in response is, why don't you use the present laws? The industry is doing that now.

We just had a case with Brazil where we found a very significant countervailing duty and dumping action, and we have had to impose those restraints because there was a subsidy, and we responded. The laws are fully adequate to defend against unfair competition. Use them. Don't come in with something that will not work.

Mr. DOWNEY. Well, in light of your strong concern about quotas, how then do you defend the sugar quota that is currently in place?

Ambassador BROCK. I do not.

Mr. DOWNEY. You would favor then legislation I have introduced that would abolish the sugar quota?

Ambassador BROCK. You have me in a somewhat difficult position. I am not in a position where I can address sugar because of my own circumstances.

Mr. DOWNEY. I do not enjoy doing this, Mr. Secretary, but I do think that if you are going to make a decision between who you are going to provide quotas for and who you are not, to argue that the 12,000 or 14,000 sugar growers in this country are as important or more important than the steel industry I think is a little hard argument to sell.

I agree with your point that a lot of the problem that the steel industry has had is some mistakes they have made themselves.

Ambassador BROCK. Not just mistakes, but other people are good competitors. Technology is changing the world in which we live in all areas. You cannot put all of the blame on management error. It is just the world we live in.

Mr. DOWNEY. Thank you, Mr. Secretary.

Chairman GIBBONS. The problem about this very informal way we are proceeding is I sometimes forget where we left off. [General laughter.]

Mr. Brock, you had a full statement. I do not know whether you had covered it or not.

Would you like to proceed, or do members have other questions at this stage?

Ambassador **Brock**. Well, I covered a good deal of it. What I did not get to was a couple of comments on some of the remedies. I do think that a bit of the discussion I have heard in the last couple of weeks on the possibility of imposing an across-the-board surcharge ought to be shot down hard and quick now. The idea that we can solve a trade deficit by imposing a duty on all imports I think ignores the essence of the problem, which is the strong dollar. If you want to make matters worse, impose a surcharge because that would increase the value of the dollar, not decrease it, and would make our exports even more, or even less competitive and exacerbate the problem. I just wanted to make some quick reference to that.

Let me take you from what has been a pretty gloomy look at the situation and try to turn it around and be a bit more optimistic because we have seen some change in the value of the dollar in the last 4 to 6 weeks which would argue for some improvement in our trading prospects, if not in 1984, certainly in 1985. It is my own personal judgment that the trading situation will continue to deteriorate a bit further because we are still suffering from the extremely high value dollars that we had in 1983. But as the reduction in the value of the dollar which has occurred recently and which apparently will continue for a bit more, in my judgment, as that translates into trade terms in late 1984 and through the middle of 1985, you could find this country in a far more competitive situation.

And frankly, when we were talking earlier I think with Congressman Pease about our industrial competitive situation, a dollar that was about 20 percent below its peak in 1983 would have put this country in a position where if it had gone down as it has in the last 2 years very significantly, in a remarkably advantageous position vis-a-vis the rest of the world, then our opportunities would be very sizable in Europe and in Asia.

I want to caution you that the opportunities still will be very constrained in the debtor countries, particularly in Mexico and in South America. Even there we are going to do better. But you are going to have a tough time selling down there for the next 2 or 3 years, at an absolute minimum, in my judgment, because they simply face a terribly, terribly difficult circumstance, and it is going to take them a while to work out of it under the best of circumstances, and we have to pay attention to the steps we need to be taking to assist them in every possible way to restore their economic health.

Chairman **Gibbons**. Let me interrupt here because I have an area of questioning I want to go into.

What is the future deficit going to look like? How big is it going to be? And then I want to come back and talk a little later on, just to kind of warn you, about our relationship with the International Monetary Fund.

But go ahead first. What is the future deficit?

Ambassador **Brock**. If the relative decline in the value of the dollar, over the last couple of months were to continue for, say, another 5 percent, which I think is not an unrealistic guestimate, then your deficit could probably be cut 40 or 50 percent in something close to 18 months.

Chairman GIBBONS. I have seen projections that our merchandise trade deficit will be as high as $100 billion this year up from over $60 billion last year.

Ambassador BROCK. I think that is correct. I think where we are now at the present level of 1983, we have a $70 billion deficit. I think the prospect of $100 to $110 billion is very real for 1984, but at some point in late 1984 and early 1985, that is going to begin to change to our advantage, and as I say, somewhere around 18 months from now you should begin to see some tangible improvement of real consequence.

Forecasting, Mr. Chairman, is—I guess I should say I do not think very many of us have the gift of prophesy.

Chairman GIBBONS. Well, my next question goes even further into the gift of prophesy. What is the impact of this kind of deficit, trade deficit, merchandise deficit, upon the U.S. economy? What is it going to do to us?

Now, that is way out in the prophesying field, but obviously it is going to have some impact. What will its impact be?

Ambassador BROCK. The impact is in several areas. It has been of really enormous benefit in terms of helping cope with inflation. In times of boom there is not too much negative if it does not go on for an extended duration.

I do not know whether it would be possible to sustain a rate of growth which would be implied if we were producing all of this product domestically, but I doubt it, and if that is true, then the danger is not so much in the short-term circumstance we find ourselves in but in the hazard we would face if we do not deal with some of the fundamental problems which caused this difficulty.

And here I have reference to the deficit. The largest single problem we have in world trade has nothing to do with barriers or tariffs or nontariff barriers; it is the U.S. deficit itself.

Chairman GIBBONS. Our fiscal deficit.

Ambassador BROCK. Yes, sir, and what that does to our ability to compete if carried on for too long a period of time.

Mr. GUARINI. If the gentleman would yield, are we not really talking about jobs for our people? Is that not what it really comes down to, that if we do not have the productivity, we will be losing tens and hundreds and thousands of jobs for Americans that will be displaced by workers that are making products in other countries? I mean, that is true whether we have good times or bad times.

Ambassador BROCK. If the circumstance is not addressed and if there is no change in the U.S. Federal deficit, if there is no change in the extremely high value of the dollar and the extremely high rate of interest in this country, we face the prospect of the exportation of jobs over a period of time, that is absolutely correct.

Mr. GUARINI. And even if we do cut back 40 percent 18 months from now and we are down from $100 to $60 billion, that is still a terrible posture for a country like America, a leading trading nation.

Ambassador BROCK. Not really.

Mr. GUARINI. Is it acceptable to you to have a $60 billion trade deficit, the largest deficit we have ever had, sir?

Ambassador Brock. It is not acceptable, but I cannot go back and recast history which caused us to get to this point. I simply have to deal with what we have now, and to say—the one thing I do not want to do is to react with any quick fix that would make it worse in a fundamental fashion. I guess that is what troubles me about steel quota bills and things like that that are being suggested. If we take the lesson we have learned by getting into this fix and deal with it in a fundamental fashion, I do not have any worry about the future. We are still the most productive country. There is no reason we cannot compete, and there is no reason to say we are exporting jobs now. You can say that 3 years from now if we have not dealt with this problem, we will be exporting a lot of jobs, and to our great peril.

But the question is, Do we have the will to deal with it now?

Mr. Guarini. Besides the question of will, we are expecting large trade deficits regardless of economic events for many years ahead.

We do not see a light at the end of the tunnel in the immediate future. There will be several years where you expect large trade deficits from what I understand from your testimony.

Ambassador Brock. No; I hope I did not say that. I personally am a good deal more optimistic than that. I think we will see the largest deficit in 1984 we have ever seen or ever hope to see; 1985 will be substantially better but still in deficit; 1986, if the world economy continues to make the kind of progress that it shows signs of making now, we should be back in a very healthy situation.

Mr. Guarini. If I may press, Mr. Chairman, our basic problem, as I understand it, is the hard dollar, that there are undervalued currencies that we are competing against, and we just cannot compete against those undervalued currencies.

Do you have evidence that there are other countries in the world that we are trading with that, as a matter of national policy, either by design or otherwise, have kept their currency soft so that they would be in this favorable competitive position with us?

Ambassador Brock. There are a lot that feel that Japan did that in the 1970's. There are very few that feel that it is doing so now.

Mr. Guarini. Japan is trying to correct the situation somewhat. But Japan still restricts the yen on the world market. And other currencies are not floated on the world market as the dollar is. Will that not keep us at a disadvantage because the dollar is used as a standard, and therefore, being so much in demand continuously place us at a competitive disadvantage?

Ambassador Brock. We all look at the negative side of the dollar being the world's reserve currency. Everybody else looks at it and says gee, we wish ours were the world's reserve currency.

Mr. Guarini. For nationalistic pride, I like it. I am just wondering whether it is costing us something to have this false pride.

Ambassador Brock. Not really. It is for our business people, the dollar is the world's currency, and it makes it much easier for them to do business in the world because the dollar is the world's currency and not just ours. So in the sense of international competition, I think our manufacturers, our business people, are advantaged by having that. I really am not troubled by that. I am troubled by the underlying factors which caused the dollar to rise at a level to which, or to a level at which it is very tough to compete.

Mr. **Guarini**. Is there any positive action we could take to eliminate that problem?

Ambassador **Brock**. Make a commitment on the Federal deficit.

Mr. **Guarini**. That is one, but it is not a panacea for every problem in America. There must be a lot of other solutions.

Ambassador **Brock**. Without it, nothing else would work. It is the cornerstone. It is the first and most important step; that downpayment, if you want to call it that, does have to be made, and it has to be made in a sufficient number for people to make a decision that interest rates are not going to be pushed back up and that inflation is not going to explode on us again.

Mr. **Guarini**. When we are talking about productivity, should it not bother us that there are three times more engineers being educated in other countries per population than within our own country, that they are making scientists and we are making lawyers?

Ambassador **Brock**. Now you are talking things that are really important for the long term, and I want to suggest that there are two areas where I think we really have to do a far better job if we are going to be competitive. No. 1 is precisely in the area you are talking about, that is, the whole educational skill area. We are not doing anything close to enough to deal with that problem, and we have a lot of work yet ahead of us.

Mr. **Guarini**. Do you have some positive suggestions to make in that regard?

Ambassador **Brock**. There have been a lot of suggestions, for example, to allow a tax credit for business support of higher education, of research grants and things like that. One of the things that we have seen is the absence of teachers to teach engineers, physics, chemistry, math, and so forth. Why? Because these professions are in such demand that they are being hired away from the classroom into the corporate laboratories, and we have to reverse that because we are depriving ourselves of our future human capital pool, and that is something that we in this administration and this Congress have to start wrestling with quickly.

Mr. **Guarini**. I agree.

Ambassador **Brock**. The other thing is the seed corn of R&D, and I do think that you all have before you the extension of the R&D tax credit bill.

Mr. **Guarini**. Yes; we have extended it in the past and passed favorable measures for research and development.

Ambassador **Brock**. I congratulate you. I think that is awfully important that we make that commitment as a country to extend and expand our R&D efforts in every possible way that we can.

The last thing I would mention, Congressman, is the Federal deficit. Other countries have a higher percentage of their GNP going into deficit. Why do they not have the same difficulty we do? One of the reasons is that they have a much higher rate of personal savings. Now, part of that is just the population ethic.

Mr. **Guarini**. Do you think that is cultural?

Ambassador **Brock**. Part of it, but part of it is incentive.

Mr. **Guarini**. We need more IRA's and programs of that sort to get people to save?

Ambassador **Brock**. Whatever will get people to set aside from today's consumption for tomorrow's rainy day, if you will, would be in our national interest. Any tax system that motivates savings and investment rather than consumption would be an improvement, in my judgment.

Mr. GUARINI. Would you be for abolition of the corporate tax?

Ambassador BROCK. There was an interesting proposal——

Mr. GUARINI. I did not mean that seriously, but you can answer it seriously.

Ambassador BROCK. We are waxing a bit philosophic here. There was an interesting proposal made back in the early 1970's by someone, to have an attributed tax. In other words, corporate earnings would not be taxed at the corporation level but at the ownership level. Even though the dividends were not paid, the earnings would be as if paid to an individual so that you could make it progressive and not put the burden on the corporation, which means on the consumer.

Mr. GUARINI. It is like a subchapter S where you pass it down to the individuals.

Ambassador BROCK. I do not know if it would be quite that easy, but something like that.

Mr. GUARINI. But there would not be a double layer of taxation.

Ambassador BROCK. That is right. What I would like to do is take a look at the whole tax system, and maybe I do have a special feeling about it because I think I look at the competitive disadvantage we face with other countries, and it seems to me that even in just basic trade terms we ought to ask ourselves is our tax system sufficiently designed for competition in the global environment? And I think we might need to look at that.

Mr. GUARINI. The last chairman of the Ways and Means Committee believed there should be a VAT tax to make us more competitive with foreign markets that are able to take advantage of that in computing what is dumping and what is not dumping, and Mr. Ullman is not with us anymore.

Ambassador BROCK. Well, wisdom is not always rewarded.

Mr. GUARINI. Thank you, sir.

Chairman GIBBONS. Mr. Anthony, you looked like you wanted to inquire down there.

Go ahead.

Mr. ANTHONY. Mr. Chairman, thank you for allowing me, a nonmember of your subcommittee, this opportunity to speak.

Chairman GIBBONS. We do not just allow you, we welcome you.

Mr. ANTHONY. You talked about inflation a while ago, and that was the good side. The downside, as I understand it, is that we are running an inflationary fiscal policy but a disinflationary monetary policy. Therefore it is the Federal Reserve that we have to applaud for keeping the inflation rate down.

What Mr. Guarini and Mr. Pease and some others have mentioned concerns me as well. That is the over valuation of the dollar. All of our business people tell me that the rate of the dollar affects their plans to build plants and equipment overseas. They have the plans on the drawing board, and in fact, many companies have already built plants. We are now seeing an exodus of those plants because, my business people tell me, they are losing at least 33 percent of the foreign markets. You zeroed right in on one example, the Latin American countries. American companies worked hard over the years to develop these markets, and now, because of either monetary or fiscal policy they are losing them. The business community is mad at the government because, they say, government policies encouraged them to reach out, which they did and now the government's fiscal monetary policy is undermining their efforts.

Let me try to quickly summarize what I have heard today, and then ask what I consider to be a simple question.

A high real interest rate: First, brings in money to finance our debt; second, overstates the value of the dollar; third, kills our exports; fourth, slows down the domestic economy; fifth, helps debtor countries export; sixth, helps debtor countries earn foreign exchange; and seventh, helps debtor countries repay its loans to U.S. banks. My question is, Should monetary policy be directed toward helping our domestic companies, or directed toward helping our foreign debtor countries?

Ambassador **Brock**. Obviously I would prefer the emphasis to be on the United States but I would point out to you that the monetary policy of the United States cannot operate in isolation of fiscal policy, and we have had this debate for a long time as to which is the greater impact. Sometimes it is one, sometimes it is the other, but I do know that they cannot constantly compete with each other, and that is what is happening now. That is why the deficit is such a problem. It is a lot more than a hangover from past difficulties. It is a present pressure that causes us to make uneconomic actions as a matter of course, and it is extremely difficult for us in the trade area because we are getting whipsawed, in all honesty, by a policy over which few of us have any control at all.

Mr. **Anthony**. Well, I hope to get Mr. Paul Volcker's views on this issue at a later date.

I have just one more question, dealing with quotas, surcharges, and tariffs. I want to bring one section to your attention and ask you to respond, not necessarily today, but maybe later on, for the record. It is my understanding that, under the softwood section of the Tariff Code, lumber comes into the United States free. I am speaking now principally of Canada, to the extent that they have captured over 35 percent of our market.

Mr. Pease, you are worried about the automobile industry. Very few people realize that Canada exports into the United States over 35 percent of the lumber that is consumed in the United States. I do not hear a great uproar about that. On the plywood side there is a 20-percent tariff on plywood with softwood faces, or made out of softwood. This discrepancy does not make sense to me. The same raw product, wood fiber, goes into two different components. Yet it is treated totally different when it comes into the United States, and it creates an undue burden on the domestic industry, as they have to compete for that wood fiber. It also creates an overprotected position for the plywood manufacturers and it creates a trade disadvantage to the people who are on the lumber side.

I would appreciate you looking at this situation, and providing me with a written response.

Ambassador **Brock**. OK, I will.

The problem with the response—and I will just give you a little advance warning—will be that it is very hard for us to recreate the negotiating position that my predecessor found himself in when he was negotiating these tariff levels in the Tokyo Round. I would also like to point out that while it may have been an eminently logical thing to do at the time, conditions change, and this has been one of the arguments that the wine industry has made, for example, that they felt left out of the Tokyo Round, and whether they were or not, they felt that way. And so they expressed that concern by introducing legislation.

You are going to find that in a lot of areas, and all we can do is try to adjust it as the world economy does, change its mix and blend.

But if I may make a self-serving point, Congressman, in 1982 in December, my authority, section 124 of the Trade Act of 1974 to negotiate in the tariff area expired, and it has not been extended, and I cannot deal with the tariff discrepancy you just described unless Congress gives me the tools with which to negotiate. And we have asked for it, we have asked for it again, and we will ask for it again this year. But I think you make a pretty decent point, and I think we could create some market opportunities as well as serving our domestic economic interests by cutting some better deals. But I have no such authority at all on the books now and have not had for slightly over 2 years. And anything you want to do to help, I would appreciate it.

Mr. ANTHONY. Thank you, Mr. Chairman.

Chairman GIBBONS. Mr. Pease.

Mr. PEASE. Mr. Chairman, if I could just interject——

Chairman GIBBONS. Let me say I am glad you made that point.

Mr. PEASE. We would be happy to extend section 124 in conjunction with other legislation as a sort of package deal, if we could put together a package for you that you would find to your liking.

Ambassador BROCK. I got my part. I would love to see yours. [General laughter.]

Mr. PEASE. I have a couple of questions.

Do you have any notion what is causing or what has caused the recent softening in the value of the dollar?

Ambassador BROCK. Not really. We have been engaged in an act of prestidigitation to keep the dollar as high as it was for the last year. I do not know how it stayed as high because all of the economic logic would have argued that the dollar should have begun to decline, at least by mid-1983, and yet it did not. It just simply held up there.

And all of the forecasts, by the way, were that the dollar would begin to decline by mid-1983. I think I was the only exception in that, and I suggested that it would hold through 1983, and it did. But I do not honestly know what is changing the market psychology. A bit of it is the sense that the trade deficit will begin to erode our economic circumstace if it continues. That is so justifiable in any economic area that you have to wonder why it has not already done it.

But that has to have its impact sooner or later. You cannot use the safe harbor argument forever. Economic reality sooner or later is going to intrude, and the reality is that the dollar has been priced in excess of economic logic, at least on the basis of the trade numbers.

Mr. **Pease**. I think we interrupted you before when you started to recite some optimistic signs, but one of the signs you mentioned was the improvement in the value of the dollar from our point of view, and you said that if the value of the dollar continues to decline into 1984, that the merchandise trade deficit could be cut by, I think, you said as much as 40 percent.

That is a big "if." We certainly hope that that will happen, but as the interest rates start to go up, as they apparently are, would that not tend to make the dollar stronger again, more in demand overseas?

Ambassador **Brock**. Yes.

Mr. **Pease**. In light of that, do you think it is realistic to assume that the value of the dollar will continue to decline in 1984 rather than to take off again?

Ambassador **Brock**. Congressman, I wish I knew what discount the market was putting on U.S. interest rates or the price of bonds, T bills today. You saw the numbers, I am sure this morning. We are marketing at 12 percent again for the first time in quite a while, and that is a very high number. I wish I knew the discount that people were putting on because of the deficit and the anticipation of a restoration of inflation. But it has to be 2, 3, 4 percent, somewhere in that range at a minimum.

Now, if that is true and if the administration and the Congress can find a way to reach an accommodation on the deficit so that we make this commitment to at least pull it down, not solve it—nobody suggests that, but at least begin to move it into a more rational range, you will begin to attack that emotional discount rate that is on there, and that will help us on the interest rates.

Let me put one other element of positive note into this equation. While we have very serious problems—evidence the story on Argentina this morning and the debtor countries—we are beginning to see sizeable growth which will help the debtor countries in Europe, greater, I think, than their own expectations. Japan is doing nicely, and Southeast Asia, almost all of Asia is doing very nicely now. So, the prospect of improved market for U.S. product is pretty real, and even with a strong dollar we should begin to make our sales more effectively overseas in 1984 and 1985. That will translate into great improvement, as well. The dollar would certainly help, but it is not the only factor.

Mr. **Guarini**. If the gentleman would yield, if we could have more trading partners like Korea that just came over here and said that we have a $2 billion trade surplus with the United States and we want to spend and invest this surplus with the United States. If Japan and some of our other trading partners did something like that, we would be in better shape.

Unfortunately, people in Japan come here and they buy theater tickets on Broadway and take all the money back home with them. [General laughter.]

Mr. **Pease**. Mr. Chairman, I think that is all for the moment.

Mr. **Jenkins**. I have some questions.

Chairman **Gibbons**. Sure, go ahead.

Mr. **Jenkins**. You anticipate during the latter part of 1984 into 1985 that there will be considerable improvement in the trade situation.

Now, what are you basing that on?

Ambassador BROCK. I am basing it on the fact that when a currency changes its value, it is no less than 6 months but usually no more than 18 before it begins to show up in better trade. We have had modest improvement, an improvement in the sense of a slight decline in the value of the dollar.

Mr. JENKINS. Do you expect that to continue?

Ambassador BROCK. Most people think that will continue a bit further.

Mr. JENKINS. Are you basing that speculation upon the continued decline of the value?

Ambassador BROCK. Part of it is because of the decline in the dollar, but part of it also is on the global recovery. A lot of our pain came out because of recession in every other country, and the recovery in Europe seems to be exceeding their estimates. The recovery is beginning lightly in the Americas, and that prospect is not going to change too much, until later in 1984 and 1985. And it is substantially better in Asia. So the sales prospect is pretty good out there. They will do better not just because of the dollar, but because of the demand for goods and services.

Mr. JENKINS. From your statement a few moments ago, you totally reject the argument that very large deficits on the fiscal side really have little meaning because the percentage of debt as to GNP is still relatively low. Many people are making the argument that we should not get too upset about a rather substantial deficit. What you are saying is that that is a very critical area.

Ambassador BROCK. Congressman, we are very big and very rich and very powerful and a very productive country. We can endure almost anything for a period of time, but we cannot endure this for a long period of time. We are going to sow the seeds of real agony if we do not make some commitments to deal with it over the next 5 or 6 years, and make that commitment fairly soon.

Mr. JENKINS. It appears that the interest rates will continue to stay rather high for a while, maybe continue to increase.

Why do you think the value of the dollar is going to decline? In the face of that it would appear to me that we would continue to attract more and more money from foreign sources.

Ambassador BROCK. Well, you have got two offsetting trends or currents in the equation by which people value currency. Part of it is the interest rate that they get, and that has been a major factor so far. But part of it is what they think the intrinsic value of that currency is.

Now, if they begin to believe that this trade deficit is of sufficient magnitude as to sooner or later begin to do damage to us, if they begin to believe that we might, by failing to deal with the deficit, restore a rate of inflation in this country that is unacceptable, then the intrinsic or real value of the dollar will in their estimate fall, and that means that they might begin to sell rather than to buy dollars.

Mr. JENKINS. As they pull out the dollars, we do not have the money for domestic expansion, is that right?

Ambassador BROCK. If that happens, Congressman, we have got the worst of both worlds because at that point we are going to get those dollars. We are so big and so powerful, we will get the money, but we are going to pay for it, and we will pay through the ears.

Mr. GUARINI. Excuse me, if the gentleman will yield.

A perfect way of making a soft dollar is if all of the people who have been investing funds with us from overseas reinvest their funds elsewhere, we would have a soft dollar almost immediately.

Ambassador BROCK. Mr. Chairman, I am not sure where else you want to go.

Chairman GIBBONS. Well, if you have any more points in your formal statement, Mr. Brock, please proceed. I realize it is pretty hard for you to keep track of what you might have covered or might not have covered. I have some more questions, but I do not want to interrupt.

Ambassador BROCK. I want to make, frankly, just two quick points. One, we have talked about all of the hazard, and it is real. We talked about the difficulty, and it is very real. But if I can lay one cautionary note at your table. When you have a time of adversity, as we do at the moment, and everything looks worse, there is a temptation to try to jump in and really stir things up and do something dramatic to impose a quick fix. I think we have a tendency in this country to do that, and have done so for the last 15 or 20 years. And it is the source of some of our present agony.

I want to plead with the committee to be very cautious in its approach to this trade problem because I think it is going to get better. I think the deficit and the value of the dollar is something that is not fundamental in terms of our domestic workers and domestic enterprises, but rather, it is more of governmental origin. If we try to intervene in the workings of the marketplace by substantial acts of protection, such as quota bills and the rest, you run the very sizable risk of making what is a dangerous situation a disastrous one.

If you want to look at the third world situation, as I did at the outset of my remarks, and the fact that our loss of sales has cost us about $20 billion in net trade in the last year or two there is one way to make that bad situation really awful, and that is to impose massive new constraints on their ability to sell into this market. They can't pay their debts, or buy our product. We lose both ways.

And I plead with you to be very cautious about considering anything of that sort.

Second, I know it is difficult at a time when we face a large trade deficit to press for positive initiatives in the trade area. However, now is the time to be talking about the steps we need to take to be competitive in 1985 and 1986, and I would make specific reference in this regard to the need to pass several important pieces of trade legislation. Every effort should be made to pass the Jones-Frenzel-Danforth reciprocity legislation which would strengthen our negotiating tools. Congress should also closely examine the need to extend our authority to negotiate on tariffs. the need to extend the GSP program, and the replacement of the DISC, all of which do provide us with the tools with which we can be more competitive in the international marketplace.

That is the essence of what I wanted to say, Mr. Chairman, this morning.

Chairman GIBBONS. Fine.

Well, we will, without objection, at this point place your formal statement in the record.

[The prepared statement of Ambassador Brock follows:]

STATEMENT OF HON. WILLIAM E. BROCK, U.S. TRADE REPRESENTATIVE

I am pleased to be with you today to discuss the U.S. foreign trade deficit and the role of trade policy in dealing with this problem.

As we are all aware, our merchandise trade balance has deteriorated significantly since the beginning of the current recovery. I will touch upon several factors underlying our deficits in my testimony today. These will include: Our rapid and strong economic recovery; the international debt crisis which has depressed economic expansion in a number of advanced developing countries; and the high international value of the dollar.

I will also dicuss what I believe is an erroneous impression created by our rising trade deficit: namely that the deficit is the result of a broad-based deterioration in the fundamental competitiveness of U.S. industry. I will conclude by discussing the role of trade policy in dealing with the deficit problem: what trade policy can do, what it cannot do and what I believe is the best course to follow under the current circumstances.

Before beginning my analysis, let me give you some figures that illustrate the magnitude of the deficit problems we are facing. In dollar terms, the deficit has grown from $40 billion in 1981 to $69 billion last year. Our own forecast is that the deficit may exceed $100 billion this year.

Within this overall deficit much attention has been focused on our large bilaterial deficits with Canada and Japan. The deterioration of our trade balance, however, has actually been worse in other areas of the world. From 1981 to 1983 our trade balance deteriorated by $4 billion with Japan and $7 billion with Canada. With Western Europe our balance declined by $11 billion and with the non-OPEC developing countries by nearly $23 billion. Only a $20 billion improvement in our balance with OPEC due to moderating oil prices offset deterioration elsewhere.

The deterioration in our trade has been concentrated in the manufacturing sector. Our surplus in agriculture slipped only moderately, from $21½ billion in 1982 to $20 billion in 1983. Our agricultural exports have, however, fallen by more than $7 billion since 1981. Our petroleum imports dropped by $8 billion last year so that our deficit for all raw and semi-manufactured materials including petroleum actually declined from $49 billion in 1982 to $46½ billion in 1983. However, in the highly competitive and price-sensitive area of manufactures, which accounts for roughly two-thirds of our total trade, the U.S. balance shifted from a small surplus of $4 billion in 1982 to a deficit of $31 billion in 1983.

U.S. firms and workers especially in the traded manufactures sector have felt increased competition as our overall trade position has weakened. The volume of our manufactured exports has declined by nearly a quarter in the last three years while manufactured imports have risen by 23 percent. Our strong domestic recovery has provided some relief to U.S. producers facing international competition. Nevertheless, the reduced price competitiveness of U.S. exports in world markets and rapid increases in competitive imports have compounded the pressures on vulnerable sectors of the U.S. economy, especially in industries like autos, steel, textiles and footwear. And, domestic firms and workers under strong import competition have reacted by greatly stepping up calls for import relief.

Even when we consider U.S. trade more broadly to include services, the U.S. trade picture is one of a deteriorating balance. For over a decade our increasing surpluses in services trade have tended to offset merchandise trade deficits. Frequently when merchandise trade alone has been in deficit we have shown a small surplus in total trade in goods and services. In 1982 the balance on goods and services showed a deficit of $3 billion—a small amount in comparison to over $700 billion in total export and import transactions. In 1983 the goods and services balance slipped to a deficit of $32 billion. A strong dollar and poor economic performance abroad contributed to a moderate decline in our services surpluses. The surplus on private service industry trade, excluding earnings of foreign investment, fell from $7½ billion in 1982 to just over $6 billion in 1983. The surplus on foreign investment earnings likewise declined somewhat from $41½ billion to $36½ billion.

Many are legitimately concerned today about the impact of the trade deficit on our economy and problems such imbalances in world trade pose for our ability to maintain and expand the open world trade system. To develop effective methods for dealing with the trade problems which beset us require some understanding of the causes of deficits and how we have arrived at this unprecedented situation.

The oil crisis of 1979/80 and the inflationary spiral which it aggravated, resulted in several years of world-wide recession. As a result, world trade declined by 1 percent in 1981, dropped another 6 percent in 1982, and grew only 1 percent in 1983. The deterioration of our trade position is in part attributable to an earlier and stronger recovery here in the United States than abroad. This is a normal circumstance in a world recovery as the economic leader draws imports from the rest of the world before demand for its exports rises. As the rest of the world experiences a stronger recovery, it will begin to boost our exports and improve our trade position. The somewhat weak outlook for economic expansion abroad in 1984 and even in 1985, however, could slow the improvement of our trade position. This is particularly true with respect to Europe where economic rigidities, subsidies and excessive economic interference by governments have sapped the dynamism of the continent. This is also true in many developing countries suffering under the burden of unprecedented foreign indebtedness.

Stronger growth abroad would help improve our trade balance and reduce current trade tensions. Throughout most of the post-war period, world trade was an engine of growth, expanding faster than world GNP and therefore stimulating world-wide economic expansion. Although there is little we can directly do to affect the internal policies of foreign nations which reduce their economic performance, we can pursue cooperative efforts to get the trade-and-growth engine of the world economy functioning again. One of the most important challenges we face in the area of trade policy is, in fact, to start world trade growing once more.

There is wide recognition that international trade, investment and monetary policies need to be focused on the expansion of trade. In the current economic environment there is a particularly close relationship between trade and finance. No where is this clearer than in the case of the high debt LDCs.

North-south trade grew faster than any other area of trade in the 1970s, providing a major stimulus to economic growth worldwide. During the 1970s, the LDC market for U.S. exports rose substantially. Their share of our total exports rose from 29 percent in 1972 to 35 percent in 1979. The growth was even stronger in manufactures where their share of U.S. exports rose from 28 percent to 38 percent. The strong export performance of U.S.-built machinery and other capital goods in the last decade was in part made possible by the strong markets in LDCs where such equipment is required for economic development purposes.

Rising oil prices, exploding interest rates and deepening world recession after 1979, however, left a number of LDCs with serious debt problems. The external debt of these countries reached $664 billion in 1983, up $52 billion form the previous year. Because of serious problems in servicing such massive debt, many developing countries have had to cut back imports by as much as 20 to 40 percent.

The debt situation has caused particular problems for our own exports. Well over one-third of the LDC debt and some of the severest problems in debt servicing are found in Latin America where the United States has particularly strong trading interests. The efforts of these countries to trim their imports have been strongly felt by U.S. exporters. From 1981 to 1983 our trade balance with the eight high debt Latin American countries deteriorated by a staggering $20 billion from a surplus of $5.8 billion to a deficit of $14.5 billion. This accounts for over two-thirds of the deterioration in our total trade deficit with the world in these two years.

Supporting the LDCs in adjusting to their heavy debt burden through financial assistance and open markets is not only in their interest but our own as well. It is crucial to a strong recovery of our exports. Let us not make the mistake we made some 53 years ago when another international financial and economic crisis led to the Smoot Hawley tariff. One of the few who spoke out against this ill-conceived act which had such disastrous consequences was a member of the Senate, a Democrat, I might add. Let me quote him.

"America controls about 70% of the world's gold. She is a creditor in enormous sums for many of the European countries, and is wanting to collect her money, while at the same time she is building up a tariff wall so prohibitive that other countries cannot send their products to America, and thus are prevented from paying the debts they rightfully and admittedly owe. These foreign countries are not to blame. They do not want a tariff war with us. They want to buy our goods, which we sell to achieve prosperity at home. But they have no choice. There is no way in which they can buy our goods unless we permit them to sell us something.

"In comparison with the same months a year ago our export business has fallen off at the rate of $2 billion per year, and the difference between this country's satisfactory and unsatisfactory business condition is in its export trade."

I have taken a personal interest in that statement because, as it turns out, it was spoken by William E. Brock, Senator from Tennessee, my grandfather.

In order to once again expand their imports, the high-debt LDCs will have to increase their foreign exchange resources through higher exports, foreign investment, multilateral assistance and better access to trade financing. Secretary Regan and I have worked steadily to develop better coordination between the trade and finance officials worldwide as the linkage between the indebtedness of these countries and their trade practices has grown. It has been especially important that financial and other measures taken to assist high debt LDCs support a rapid recovery of world trade. We have provided Eximbank guarantees and insurance and Commodity Credit Corporation guarantees to finance LDC trade, thus enabling them to import essential goods. The Eximbank has provided expanded packages of guarantees for both Brazil and Mexico. We have also supported the use of bridge financing, increased resources for IMF loan programs, and the reduction of barriers to foreign investment in these countries. Above all, however, the recovery of these countries depends on their ability to export which in turn depends on their ability to obtain market access in the developed countries. In this regard, the Generalized System of Preferences (GSP) program affords preferential access to LDC exports and assists them in earning the foreign exchange needed to honor their debt obligations. The extension of this critical program which is pending before this Committee represents a lifeline to many of the developing countries of the world.

The foreign exchange value of the dollar is also a key matter of concern. Since 1978, to the beginning of this year, the dollar rose 14 percent against the yen, 27 percent against the German mark and 69 percent against the French franc. In effective terms the dollar rose by 40 percent. As a result, otherwise competitive U.S. producers are being priced out of our own as well as foreign markets by a dollar that has experienced an exceptional increase in a very short period of time.

The factors determining the dollar's value are numerous and complex. It is clear, however, that the dollar's current value is being supported by substantial movements of foreign capital into U.S. markets. Foreign investors buy dollars with foreign currencies in order to invest here; this has the effect of bidding up the value of the dollar in foreign exchange markets and reducing U.S. price competitiveness in trade.

There are several considerations behind the large capital inflows supporting the dollar. We are the world's most prosperous and stable economy. And thus the dollar has become the world's hedge in periods of crisis—and there have been many. In a more geographic sense, capital in flight from politically volatile regions of the world finds safe haven in the United States. Our vigorous recovery and expansion as well as our open investment policy have also attracted foreign investors. And, the fact that real interest rates in the United States are well above those in most other countries has stimulated the inflow of short-term foreign capital in search of maximum return.

Foreign investors could decide for a number of reasons to reduce the flow of their investments to the United States which would lead to an easing of the dollar and some improvement in trade. In fact there has been some tendency since the beginning of the year toward a depreciation of the dollar's value. Policy choices to sustain this movement are limited, however. There is nothing we can or should do to reduce the safe haven aspect of our economy, other than to pray that other nations will find the peace we so enjoy. Nor do I question the desirability of open investment policies. This leaves the problem of high real interest rates.

Our high interest rates in part result from the fact that our current national saving is inadequate to finance both Federal deficits and the private credit requirements of an expanding economy. Recent surpluses in state and local government accounts have helped limit the gap between the national saving and national investment. A gap, however, still remains and is being made up in a financial sense by capital inflows from abroad. Last year net foreign investment in the United States amounted to $35 billion, or about 7½ percent of private domestic investment. Capital inflows, however, were on an increasing trend during the year, reaching an annual rate of $58 billion by the fourth quarter or 11 percent of private domestic investment. Relatively high interest rates are a condition for attracting this foreign capital. Our financial borrowing from abroad manifests itself in a real sense by importing more goods and services than we export. We cannot have both a sustained economic expansion at home and a more competitively valued dollar for trade purposes unless we are able to substitute increased domestic savings for foreign credit.

The exact relation between the size of the Federal deficit and interest rates is subject to considerable debate; however, few would argue that government borrowing to finance increasingly large deficits reduces interest rates, or is even completely neutral with respect to rates. Reductions in future Federal deficits are essential to our long-term domestic economic health, and they are essential to any improvement in our trade account.

The unprecedented size of our trade deficit has raised questions in the minds of many about our competitiveness. While it is clear that the high value of the dollar has seriously eroded the price competitiveness of many U.S. producers, there has been a tendency to overstate the extent of our competitive problem.

U.S. competitiveness in world markets in the long term depends on the performance of our domestic economy in areas such as technical and product innovation, adoption of advanced plant and equipment, investment in education and human skills, and a healthly rate of output and productivity growth.

Our economy performed better during much of the 1970s than is often realized with real per capita income rising an average of 2 percent a year, faster than the 1950s rate of 1.4 percent and only somewhat less rapidly than the 1960s rate of 2.6 percent. Our productivity performance, however, did falter as the staggering increase in oil prices rendered a good deal of U.S. capital equipment obsolete and as employment swelled by 20 million to accommodate the rapidly growing labor force of the 1970s. I might add that the economic problems of spiraling inflation and strained capital resources accumulated by the end of the 1970s and created a sombre outlook for the future of the economy at that time. Through incentives to capital investment like the acceleration of depreciation allowances, through reductions in regulatory burdens and taxation, and through success in bringing down inflation, the basis has been laid in the last three years for sustained non-inflationary growth and solid gains in both productivity and employment, which rose by 700,000 last month and by close to 5 million since the recession's end.

The slackening productivity growth in the 1970s may have contributed to U.S. loss of world trade market share in the last decade. The U.S. share of world manufacturers exports was 16.4 percent in 1980, down from 18.4 percent in 1970. Our share did, however, recover somewhat to 18.1 percent in 1981 and 17.3 percent in 1982.

The evidence does not suggest that we are deindustrializing. Since 1970 industrial production in the United States has risen by 41 percent, more than Canada's 37 percent, France's 32 percent, Italy's 23 percent, Germany's 20 percent or Britain's 12 percent, although not as rapidly as Japan's 57 percent. Even since 1980 when the dollar began to rise, the index for manufacturing production has risen 6 percent and is still rising steadily. Whatever the impact of the domestic determinants of our long-term competitiveness such as innovation, investment and productivity, they certainly have not led to U.S. deindustrialization.

The unprecedented size of our trade deficit is to a large extent the result of U.S. and world macroeconomic factors such as the strong U.S. recovery in advance of the rest of the world economy, LDC external debt and the inadequate level of U.S. net savings. I do not believe that our trade deficit reflects any broad based decline in our fundamental industrial competitiveness. This is not to say that a weakened dollar would spare every U.S. industry from structural adjustment pressures from competitive imports. To deal with such industry specific situations, however, we do have trade laws which we have used and will continue to apply. But I do not believe that the traditional industry-specific tools of trade policy are particularly appropriate or effective for substantially reducing the current deficit.

There are, of course, serious problems of market access for our exporters in foreign countries. We are vigorously seeking the reduction of barriers to our important agriculture exports as well as to manufactured goods. In addition, the Administration has been exceptionally active in enforcing U.S. trade law to protect the interests of U.S. firms and workers when injured by unfair foreign trade practices. These efforts will continue. But we must also understand that the growing size of the U.S. trade deficit is for the most part not directly caused by either U.S. trade policy or foreign trade practices. If we are to successfully respond to the problem of the trade deficit, we must deal with its underlying causes found in the forces shaping our overall balance-of-payments position and the exceptional value of the dollar.

While there are provisions in our trade law to deal with macroeconomic aspects of our trade problems, we have to be sure that their use is not counter-productive. In fact attempts to employ trade policy to reduce the current deficit may actually backfire and worsen rather than improve our situation. Such, I believe, would be the case with respect to action under Section 122 of the Trade Act of 1974 to impose an across-the-board import surcharge. Such a surcharge would not just tend to reduce imports, it would also tend to strengthen the dollar or moderate its decline. The dollar's value is determined each day in foreign exchange markets by conditions of supply and demand. Limiting imports, also limits the supply of dollars in foreign exchange markets thus appreciating its value.

Under a flexible exchange rate the principal indication of an incipient balance-of-payments deficit is a tendency for the dollar to fall in value. Section 122 provides for the imposition of an import surcharge precisely to prevent an imminent and significant depreciation of the dollar. It makes little sense to impose a surcharge when the best hope for improvement of our trade balance is just such a moderation in the dollar's exchange value. The result of a surcharge then could be to further strengthen the dollar and reduce the ability of U.S. exporters to sell abroad. We could very well drive down both U.S. imports and exports while obtaining very littel improvement in our trade balance.

What then should we do to improve the difficult situation of our foreign trade deficit?

First, I think we must face the uncomfortable fact that even though our exports are beginning to grow again, our trade deficit will increase further before it begins to improve. Even a rapid and substantial deterioration of the dollar would require 12 to 18 months to have sizeable effect on the U.S. trade balance.

Second, actions to reduce Federal spending and deficits as well as measures that increase domestic savings are highly desirable from the point of view of foreign trade. The cost of growth should not be a high dollar; the less we need to borrow from abroad, the stronger our overall trade performance can be.

Third, we must resist demands for protection warranted only by competitive pressures from the overall deficit. Such protectionism for some sectors would be at the expense of other U.S. workers and producers. It would create economic distortions here at home reducing our ability to accomplish necessary economic adjustments to a changing world economy while contributing little to the solution of our trade problems.

Fourth, we should recognize that time will work in our favor internationally. Further recovery abroad will improve demand for our exports; the movement of our domestic economy to a sustainable long-term growth path will moderate the recent torrid growth of U.S. demand for imports.

Fifth, we must continue to strictly enforce our trade laws so that U.S. firms already suffering from strong foreign competition are not forced to face the added burden of competing against foreign governments. We must be able to ensure that Americans are not unfairly deprived of their jobs by foreign government intervention. We are aware that other nations have been critical of some of the trade actions taken by the United States. But let us all understand the distinction: there are cases when certain actions are not only acceptable, but are ethically and legally right. These actions, taken in accordance with U.S. law and international law, must not be confused with protectionism.

Lastly, we must continue to work with our trading partners to ensure the expansion and liberalization of world trade in the years ahead.

I thank you for this opportunity to present my views on the problem of the trade deficit.

Chairman GIBBONS. Let me call to the attention of the members that we are expecting Mr. Draper, soon, of the Export-Import Bank, but I have a few more questions.

Has Mr. Draper arrived yet?

Yes, here he is.

We will be with you in a minute, Mr. Draper. We are glad you are here.

Mr. Ambassador, if the dollar falls and falls substantially enough to make an impact, how long will it take before this impact is felt in the statistics and in the marketplace?

Ambassador BROCK. You will begin to see marginal response certainly of the quick traded items in 6 months. You will not, however, see fundamental change, in my judgment, for a minimum of 12 months, and the full impact will take about 18, if history is any precedent.

Chairman GIBBONS. One of the things that has worried me concerns the IMF. I want to say here for the record that we have had a nice exchange of correspondence with the IMF. They have said that it is their policy not to come and testify before committees of the Congress or any other body, since they are an international agency. It kind of worries me about who they may be accountable to, but perhaps there is some way we can work this out. I do not want to give anybody the appearance that we are throwing stones at each other, but one of the things that worries me is that in this whole picture, in our concern for the financial institutions—the U.S. financial institutions, the international financial institutions—we took good care of them. Through the IMF principally—and I recognize the IMF is not driving the international trade picture—we took good care of the financial institutions, because the IMF said to these debtor countries, pay up your interest obligations by cutting your imports and exporting at any price.

Now, they probably did not say it quite as casually as I stated it here, or perhaps not as directly, but that has been the result of it, and we have had a tremendous dropoff in exports. It seems like to me there could have been perhaps a more moderate or perhaps a better orchestrated scenario in which they said yes, we have got to preserve the banks. We cannot let them collapse because of the damage that it will do to our entire economy but they are going to have to take the stretchout in all of this with the rest of the American economic system, our farms and our factories. It looks like our farms and factories have paid the full cost of our mistakes or the mistakes of the world, but the moneylenders have been able to come out without any damage at all or any stretchout at all to their institutions.

Now, I realize some of them got so greedy that they really ruined themselves, but they were very limited. We seem to be more interested in protecting our financial institutions than we do our farms and factories and the people that work in the farms and factories.

I do not know what your observation is of this, but it seems if we ever get into this predicament again, we perhaps ought to have a more coordinated or better coordinated Government policy about who is going to have to pay for the excesses of the past. It is obvious that the moneylenders have not had to pay for the excesses of the past, and some of their rabid lending activities may be the cause of it.

Do you have any observations on this?

Ambassador BROCK. Yes. First of all, I do hope you have a chance to talk to the IMF, at least informally. I think they will tell you what they have told me, and that is that they do not ask people to export at any price or to stop imports, but rather, to put their domestic house in order. The problem began when their debts exploded and all of the external factors, such as the energy crisis, commodity price, world recession, came down on them at the same time as high interest rates.

The IMF, I have been told personally is in contact with the GATT. There is a continuing effort ongoing now to increase the level of coordination between the IMF and the trade authorities so that we can put the emphasis on expanding trade and not contracting it. At least the IMF does not intend to put all the burden on the trade, as I am sure you'll see when you have an opportunity to talk with them.

Chairman GIBBONS. Well, it seems to me, Mr. Ambassador, that they took care of their constituencies, which are mainly the moneylenders, but they took care of them first, and most effectively. I do not deny that there is some need to do that, but it looks to me like we could have a better balance of policy in that area, and it may require some kind of action by the major constituent owners of the IMF. I realize the IMF does not belong to the United States, although we sometimes act like it does, or at least pretend it does. I realize it is not our institution, it is an international institution, but it appears to me that the bankers, because of the clubbiness of their industry and the fear everyone has that their institutions will collapse, got their relief, but that farms and factories of the United States had to go the extra mile in loss of sales and production, and the loss of employment.

As I say, it is hard to define, but it looks to me as if that is what has happened. I have looked at some of these South American countries, and sure, their house is out of order, just as our house is out of order. We all ought to straighten it up. But it looks to me as if they have been told export, export, export, and they have done so, even if they had to subsidize it to get it into this market. And they have been told not to spend, and they have not spent. Our sales to Mexico have dropped by $4 billion alone, just Mexico, and I do not know what that has done to the Mexican people. I am not here to try to solve that. But it seems to me that it is probably too late to correct the past, but as we go down this road, we are going to have to have a better working relationship with the International Monetary Fund and with our bankers—both the domestic and the international bankers—or we are going to find again that our farms and factories are having to go further than they need to, further than they themselves ought to go, while the banking community picks up its money on the table.

Now, I am not antibanking or anything like that. It just appears to me that that is what happens.

Ambassador BROCK. Well, first of all, I completely agree with the need for greater coordination. There is just no question about that, and one of the sources of continuing frustration for me, as it is for the Secretary of the Treasury, is our apparent inability to get trade and finance ministers to sit down at the same table. Right now it is, I think, true that all the finance ministers are blaming the trade ministers for the financial difficulties, and the trade ministers are blaming the finance ministers. Both of them have an adequate share of the blame. I do not think we need to put it off on anybody else. If we could do our job better, we would have less difficulty.

But in terms of the specific burden that is put on these debtor countries for adjustment, I do not think we in this country have any idea how draconian these proposals are for a remedy for countries such as Brazil. We have through our international institutions asked some of these countries to take as much as a 20-percent net real decline in personal income in 1 year.

Chairman GIBBONS. I have seen it, I have seen it.

Ambassador BROCK. And I am telling you, we would have the Capitol in flames if you suggested anything like that around this country. You are talking about, if we were trying to do the same thing, balancing the Federal budget in this country in a period of 2 years and increasing the tax on every American citizen, man, woman, and child, by $1,000 a person overnight. That is what you would have to do.

Chairman GIBBONS. I do not see how they have kept the lid on, frankly. I admire the way they have been able to do it.

Ambassador BROCK. I think they have shown a lot of courage, and it has been tough.

Chairman GIBBONS. Well, of course, in Brazil it is not a democratic society. They are moving in that direction very rapidly, and I do not want to comment on Mexico, but you seemed to reinforce what I have said here, which is that the IMF's policy, as right as it may be, did not take into consideration what damage it was doing to our farms and our factories, and perhaps even what damage it was doing to the political stability of these other nations. And I do not know how—I am not trying to take over the IMF; let me make that caveat real quickly—I do not know how we get a better governmental dialog with the IMF.

The United States, as I understand it, owns 25 percent of the capital stock in the IMF, is that right? That is hardly control, although in most institutions you would have a lot of voice.

What I want to know is what kind of machinery do we have in this country that attempts to coordinate that policy? Do you have any direct input into the IMF? Who in this Government does have the input into the IMF?

Ambassador BROCK. The normal and routine and regular contact is with the Secretary of the Treasury and his Department. I have contact because we do have some shared problems, and we obviously are concerned with what they do, and try to be supportive and helpful. But their official contact point is the Treasury Department.

Chairman GIBBONS. Well, it is obvious that this committee and perhaps this Government needs to have a greater liaison with the IMF—maybe I am underestimating the amount of liaison we have now—because, as you pointed out, our exports to these countries have dropped tremendously. Those countries' ability to keep their people in a reasonable, adequately supplied position has been vastly influenced, and yet, our farms and our factories have paid the cost of that.

We are going to have some people here from the financial institutions, and I hope that they will be prepared to respond to this. It does not appear to me that the financial institutions have shared the burden as much as the farms and the factories have.

And I do not blame them. In our society you get as much as you can until you run into some regulation, and that is the way the system works. But it appears to me that since this is a new experience for us, we just have not paid enough attention to that part of the whole factor. And it is obvious that the IMF is going to be setting international trade policy, not only for the United States but for the world for a long, long period of time. And maybe we need to buy some more stock in that institution and have a little better input into it, or else have a more vigorous use of our own 25 percent.

Ambassador BROCK. Mr. chairman, I think you have got to be careful not to put more authority into IMF than it has. They are operating almost at the margin of the problem in a number of ways. I really and truly believed that the Congress showed a great deal of courage in doing what it did in extending the funding to IMF last fall. And I was convinced then, and I remain convinced that we could have had a tragic consequence had that not been done.

Chairman GIBBONS. I would agree, but go ahead.

Ambassador BROCK. The IMF operates only in that very narrow boundary of critical balance of payments crises. It cannot operate in the fundamental economic area. It wasn't designed to do that. And maybe unfortunately there is no international instrument that deals as comprehensively as the Federal Reserve System does in this country, for example.

But let me just tell you, as I'm sure Bill Draper who is in the audience will. We have done everything in this country we know how to do. Our Treasury Department, the Eximbank—we have done everything we can possibly do to deal with this, including the special facility for Mexico and Brazil, and yet the problem is so big that it almost overwhelms everything that we and the international institutions can do together.

Let me just point out to you that the collapse of credit available when the debt crisis occurred did not just affect attitudes of banks and their lack of willingness to extend the credit. A very substantial part of trade is financed by company-to-company credit, not by banks; and we have circumstances today where companies cannot even finance their subsidiaries in other countries because of the constraints of the debt circumstance and the capital controls and all the rest that have intervened there.

And what you saw in 1983 was almost a collapse of corporate credit as well as bank commercial credit. So this combination has been just devastating to the trading situation, and that really is totally beyond the yen, or authority, or jurisdiction of our Treasury Department, the IMF, or anybody else.

Chairman GIBBONS. Do my colleagues have any other questions or observations before we turn our trade representative loose?

Mr. PEASE. Mr. Chairman.

Chairman GIBBONS. Yes, sir.

Mr. PEASE. I would like to commend both you, as chairman, and Ambassador Brock for what I think has been a very helpful and enlightening exchange of views this morning.

Chairman GIBBONS. Well, I would like to commend the whole committee. I like the kind of participation we have had here. And, Ambassador Brock, we always welcome you here. You always handle yourself quite well, and you always give us a lot to think about; and we appreciate it very much.

Ambassador BROCK. The feeling is mutual, Mr. Chairman. Thank you very much.

Chairman GIBBONS. Our next witness will be from the Export-Import Bank, Mr. Draper.

Mr. Draper, we welcome you, and we will give you a little time to get up here and get seated before we start.

Mr. Draper, welcome. You may proceed as you wish, and we are proceeding very informally here; so you just go right ahead.

STATEMENT OF HON. WILLIAM H. DRAPER III, PRESIDENT AND CHAIRMAN, EXPORT-IMPORT BANK OF THE UNITED STATES

Mr. **Draper**. Fine, Mr. Chairman.

Chairman **Gibbons**. We may interrupt you as you go along.

Mr. **Draper**. I will just make a few comments that are particular to the Eximbank. But, in general, Eximbank's role, economic role, is that of a market neutralizer; that is, Exim attempts to allow market forces to determine the level of U.S. exports, to overcome market imperfections caused by the unwarranted perception of extraordinary risk on the part of private lenders, or imperfections caused by foreign governments' export credit subsidies—which are anathema to free and fluid world trade.

Eximbank can overcome these imperfections, and export decisions can be made on the basis of price, quality, and service. The importance of having an Eximbank is to carry out this neutralizing role. It is an often debated and often misunderstood subject. Because Eximbank typically supports less than 10 percent of all U.S. exports in all its programs, some observers claim that the Eximbank is unimportant to U.S. exports efforts.

However, the sectors that dominate Eximbank activities, such as transportation equipment, machinery, and electrical equipment, account for one-fourth of all U.S. manufacturing output. They account for virtually all of the U.S. capital goods output, and they are among the U.S. manufacturing sectors most dependent on exports to the developing countries for their growth and profitability.

The trade policy role of Eximbank which I just described operates within a global environment, shaped by the interplay of various economic policy forces. These forces, in turn, largely determine the focus and level of Exim activity.

The 1984 annual report of the Council of Economic Advisers describes three main factors which affect U.S. balance of trade today. First, the appreciation of the dollar, which makes U.S. products expensive relative to other countries, is identified as the most important cause for the recent increases in the trade deficit.

Second, problems in the Third World have slowed worldwide export demand. The United States has been particularly affected by debt problems in one of its most important foreign markets—as you have been describing—Latin America.

And third, because U.S. industrial production has recovered from the worldwide recession faster than that of its major trading partners, U.S. imports are rising far faster than its exports.

Given this perspective on Eximbank's objectives and the macroeconomic influences affecting U.S. trade today, I would like to comment on the Bank's role in addressing the trade problems raised by these hearings.

The problem of the overvalued dollar is a major factor influencing Eximbank activity levels. On the other hand, Exim does not have any major influence on the value of the dollar. However, if the relationship between budget deficits, interest rates, and dollar valuation is valid, then careful and judicious use of Eximbank's resources is relevant to the realignment of the dollar.

This relevance flows from the fact that the efficient use of Eximbank's resources minimizes the Bank's impact on the Federal budget deficit, and therefore helps make any correction of the dollar as feasible as possible.

Concern has been expressed over a deterioration in the U.S. current account, especially service exports. Mindful of legislation which requires the Bank to give service exports equal treatment to that given goods exports, Eximbank is reviewing its programs and policies to ensure that it is not discriminating against service exports which either face risks or financing competition problems.

The Third World debt crisis is a major focus of the Eximbank today. Given the Bank's objective of meeting market risk-taking imperfections, we took a major lead in the recent Brazilian-Mexican program that we put into place in order to stimulate the IMF and the commercial banks to lend more, more along the lines that you were describing. And I will be happy to get into that later.

The LDC financial turmoil is a major obstacle to U.S. exports, and Eximbank has taken on a leadership role in helping to keep the flow of credits moving to countries with temporary liquidity problems.

The competitive problems faced by capital goods exporters seem to be primarily a high dollar and reduced level of demand, not any lack of competitive export financing. For example, of all the preliminary commitments authorized by Eximbank since January 1983 which reached final resolution—that is, they were either won, lost or deferred—none of them were lost due in any way to the competitiveness of export financing.

Finally, when discussing overall strategies to correct the trade deficit, it is useful to note that the major avenue through which Eximbank can exert a positive influence on U.S. export trends tends to require a long-term application of stable policies. For example, it seems realistic to hope that over the years a consistently supportive and competitive Eximbank can encourage present U.S. exporters to maintain their commitment to a U.S. export base.

In summary, Eximbank's role in trade policy is to allow market forces to determine U.S. export levels by neutralizing the effect foreign credit competition and foreign country intervention in that credit and trade, and exaggerated risk perceptions of private lenders. U.S. exports can compete on the basis of price, technology and service.

I want to assure the subcommittee that Eximbank will do its part to ensure that the U.S. exporters will compete on an equal footing in the export finance area over the long term. Whether this effort will make a difference in the overall U.S. trade position will be decided by those who must address the macroeconomic issues. And perhaps you would like to get into some of those today.

But I just wanted to make that overall statement.

Chairman GIBBONS. Thank you, Mr. Draper. Does that complete your statement?

Mr. DRAPER. Yes.

[The prepared statement follows:]

STATEMENT OF WILLIAM H. DRAPER III, PRESIDENT AND CHAIRMAN, EXPORT-IMPORT BANK OF THE UNITED STATES

Mr. Chairman and Members of the Subcommittee: I appreciate this opportunity to share some thoughts with you on the role of Eximbank in U.S. trade policy and its implications for addressing the trade deficit.

Eximbank's economic role is that of a market neutralizer. That is, Eximbank attempts to allow market forces to determine the level of U.S. exports. By overcoming market imperfections caused by either the perception of risk on the part of private lenders or by foreign governments' export credit subsidies, the Bank allows export decisions to be made on the basis of price, quality, and service.

In addressing the risk needs of U.S. exporters, Eximbank participation often makes the difference between financing being available, even at market rates, and no financing on any terms or conditions. This stark choice is particularly true for borrowers in the debt-burdened LDCs. In other cases, Eximbank's risk protection may allow financing to be extended on longer terms more appropriate to the economic life of the products, which are necessary if the sale is to take place. In meeting foreign export credit competition by offering below-market-rate loans, Eximbank can make the critical difference between winning and losing an export sale. The products supported by Eximbank loans are generally financed on a long-term basis, where a one percent interest rate differential is roughly equivalent to a five percent price differential; thus, financing is an important competitive consideration.

The importance of having an Eximbank to carry out this neutralizing role is an often debated and often misunderstood subject. Because Eximbank typically supports less than ten percent of all U.S. exports in all its programs, some observers claim that the Bank is unimportant to U.S. export efforts. However, an aggregate measure such as this is quite misleading, since it masks the importance of Eximbank to certain industry sectors which face intense foreign financing competition or require term financing in LDC markets. For example, in recent years Eximbank has supported about 20 percent of all U.S. machinery and transportation equipment exports to lesser-developed countries with either long-term direct credits or guarantees. This is about the same percent of support provided by Germany and the United Kingdom to their exporters; France is slightly higher at 30 percent, while Japan stands at only about 10 percent. While the sectors that dominate Eximbank activity (i.e., transportation equipment, machinery, and electrical equipment) constitute only six percent of U.S. GNP, they account for one-fourth of all U.S. manufacturing output, virtually all of the U.S. capital goods output, and are among the U.S. manufacturing sectors most dependent on exports to the developing countries for growth and profitability.

The trade policy role of Eximbank which I just described operates within a global environment shaped by the interplay of various economic forces. These forces, in turn, largely determine the focus and level of Eximbank activity. The 1984 Annual Report of the Council of Economic Advisors describes three main factors which affect the U.S. trade balance today:

(1) First, the appreciation of the dollar, which makes U.S. products expensive relative to those of other countries, is identified as "the most important cause of the recent increases in the trade deficits."

(2) Second, debt problems in the third world have slowed worldwide export demand. The United States has been particularly affected by debt problems in one of its most important foreign markets—Latin America.

(3) Third, because U.S. industrial production has recovered from the worldwide recession faster than that of its major trading partners U.S. imports are rising faster than its exports.

Given this perspective on Eximbank's objectives and the macroeconomic influences affecting U.S. trade today, I would like to comment on the Bank's role in addressing the trade problems raised by these hearings. These trade problems include: the high dollar, the current account deterioration, the third world debt crisis, the foreign competition encountered by various U.S. industries, and the size of the trade deficit.

The problem of the "overvalued" dollar is a major factor influencing Eximbank activity levels, but Eximbank does not have a major influence on the value of the dollar. In fact, by increasing U.S. exports, the resultant strengthening of the current account could cause the dollar to appreciate even more. On the other hand, if the relationship between budget deficits, interest rates, and dollar valuation is valid, then careful and judicious use of Eximbank resources is relevant to a realignment of the dollar. This relevance flows from the fact that the efficient use of Eximbank resources minimizes the Bank's impact on the federal budget deficit and thereby helps make any correction of the dollar as feasible as possible.

Concern has been expressed over a deterioration in the U.S. current account, especially service exports. Mindful of legislation which requires the Bank to give service exports equal treatment to that given goods exports, Eximbank is reviewing its programs and policies to ensure that it is not discriminating against service exports which face risk or financing competition problems.

The third world debt crisis is a major focus of Eximbank today, given the Bank's objective of meeting market risk-taking imperfections. During the past two years, international financing flows declined as the international financial community was shaken by debt repayment crises in major LDC nations. Between 1981 and the present, medium-term international bank credit commitments have dropped significantly. This LDC financial turnmoil is a major obstacle to U.S. exports, and Eximbank has taken on a leadership role in helping to keep the flow of credits moving to countries with temporary liquidity problems. Although some borrowers are encountering temporary difficulties, Eximbank takes a long-range view in evaluating country creditworthiness. We consider that most developing countries have long-term creditworthiness, as long as they are taking mesaures to correct their temporary debt service problems. We see Eximbank as a catalyst in putting together the international financing packages needed to work out these problems. The $1.5 billion guarantee and insurance facility approved for Brazil in September facilitated an $11 billion international safety net. Eximbank played a similar role in Mexico that led to a $10 billion package for that country in 1982, with the Bank providing a $500 million facility to help meet Mexico's needs in 1983 and 1984. Of the Bank's $13.9 billion in resources for fiscal year 1984, over 70 percent will be used in risk-protection programs.

The competitiveness problems faced by various sectors of the U.S. economy are particularly evident in most of the capital goods industries, such as machinery and equipment production, typically served by Eximbank. Such capital goods exports seem to be suffering primarily from a high dollar and a reduced level of demand, not from any lack of competitive export financing. For example, of all preliminary commitments authorized by Eximbank since January 1, 1983, and reaching final resolution (i.e., won, lost, or deferred), as of March 15, 1984, none has been lost due in any way to the competitiveness of U.S. export financing. On the other hand, Eximbank's records show that the degree of U.S. price competitiveness in recent months has declined significantly, with current reports of U.S. price around 30 percent higher than those of winning foreign competitors. In addition, the incidence of project deferrals by third world countries has also cost U.S.—and foreign—exporters a sizable amount of business. Of the projects on which Eximbank has been approached for direct loan support in recent months, almost half have been cancelled or deferred by the potential foreign buyer.

Finally, when discussing overall strategies to correct the trade deficit, it is useful to note that the major avenues through which Eximbank can exert a positive influence on U.S. export trends tend to require a long-run application of stable policies. For example, it seems realistic to hope that over the years a consistently supportive and competitive Eximbank can encourage present U.S. exporters to maintain their commitment to a U.S. export base. Moreover, Eximbank—in cooperation with the Commerce Department, the Small Business Administration, and state agencies—is putting in place an educational outreach capacity that, over the next few years, could significantly increase the number of U.S. firms who participate in exporting.

In summary, Eximbank's role in trade policy is to allow market forces to determine U.S. export levels. By neutralizing the effect of foreign export credit competition and exaggerated risk perceptions of private lenders, U.S. exports can compete on the basis of price, technology, and service. The need for this neutralizing is generally concentrated in a few industrial sectors; thus, Eximbank is important to a small part of our economy but one which is critical to the U.S. industrial base.

By allowing market forces to work, Eximbank can facilitate U.S. macroeconomic policies beneficial to trade. When Eximbank consistently pursues its long-term objective, the government demonstrate its commitment to assisting U.S. exporters in meeting foreign competition and helps foster a permanent export awareness in all U.S. companies.

However, attempting to use Eximbank to offset a macroeconomic environment which is not conducive to trade is probably destined to be an unsuccessful venture. Not only is Eximbank a generally inefficient tool to use in trying to fine-tune the trade balance, but adjusting the Bank's resources levels and policies based on the short-run value of the dollar or the size of the trade deficit could undermine the Bank's ability to meet its long-term neutralizing objective.

I want to assure this subcommittee that Eximbank will do its part to ensure that U.S. exporters will compete on an equal footing in the export finance arena over the long term. Whether this effort will make a difference in the overall U.S. trade position will be decided by those who must address the macroeconomic issues.

Chairman GIBBONS. Wishing for the perfect day, I would hope that some day we could almost get out of the export financing business, but I realize that that is a long way down the road. Let me ask you:

Do you as a member of, or the head of this most important institution ever meet with our foreign competitors and try to establish any ground rules for export financing?

Mr. DRAPER. Yes, sir. We have been very active in that particular area. When I first came to the Bank, we were lending at 14, and the interest rate went up to 15½ percent. Rather, we were borrowing at those rates; we were lending at 8¾ percent interest; and our competitors were lending 100 basis points below that or 7¾ percent.

The result was that something had to be done because this overall subsidy for the three or four largest countries in the OECD was some $10 billion. So we got right in the middle of some negotiations, and we got an agreement on the aircraft programs so that Airbus and Boeing and Douglas could all compete with identical financing terms.

We have an agreement now with the manufacturers of Airbus that they will not lend at less than 12 percent interest, they will not go out beyond 10 years, and we agreed to do the same thing.

The other countries, 22 countries in the OECD, have agreed quite recently to something that we have been pushing for, which is an adjustment in interest rates. We finally got the other countries to go up in the minimums that they would allow in their interest rates, and we now have exactly competitive terms with them on our interest rates, which vary according to country and so on.

But we do have this kind of an agreement that you are talking about with the other OECD countries, and it has worked reasonably well. There are those countries that cheat once in a while. There is an attempt by some to exacerbate the problems by getting into fixed or rather mixed credits where they mix some aid in with their financing of an export in order just to buy the order, which we are trying to beat down and are meeting with them again in April.

We met with them just last week. It is a very active, ongoing, changing document and agreement that we have with them. But we do try to minimize interference of this type.

Chairman GIBBONS. Well, I realize that export financing is very complex, and I have read some news accounts of some of the competitive activities in the aircraft area. I notice that while you have probably fixed a part of the package now, the competitors are going after such things as training of flight crews as a part of the sale of the aircraft, and also the trade-in of old aircraft and all of those other things.

So I realize that you are part of the whole bargaining process. While it is very important, it is to some extent limited in what you can do about disastrous types of competition.

Is there a need for an international agreement in the area of export financing?

Mr. Draper. I think there is an absolute need, because it gets particularly complex when a group of government officials are setting the prices, in effect, for what should be a commercial sale in a foreign country, a foreign export. It gets to be very inefficient pricing and often done by bureaucrats that have no relationship to what is economic. And in some of these mixed credits, we are finding it might have been cheaper to have bought the product and given it away to the foreign country than to make the financing deals that they have made available in some cases.

We feel that an international agreement that allows countries to, in effect, buy the order merely for national pride or something is just the wrong way to go about it; and we have driven—we have knocked some sense into the heads of some of those that we have been negotiating with so that they understand the subsidies have been very expensive to their economies. As a result, they cause inflation in their economies. France, I think, is the worst example of using this very inefficient method to buy business.

Chairman Gibbons. Is there any progress being made to develop an international bargaining arrangement in this area?

Mr. Draper. Well, as I say, we have made quite a bit of progress.

Chairman Gibbons. In identifying the problem.

Mr. Draper. But in the actual agreement, they have agreed to——

Chairman Gibbons. This is within the OECD? This is just a gentlemen's agreement; it is not a binding agreement, is it?

Mr. Draper. Well, it is really binding. It is not in treaty form, I guess. But they can break it, derogate from it.

Chairman Gibbons. What peril do they suffer if they break it?

Mr. Draper. Well, there is the peril of the other countries who have many other fish to fry bringing that as pressure on them. So it has really worked reasonably well, I would say.

We find that most financing contracts that go out are on the basis of the consensus minimum rates and maximum terms.

Chairman Gibbons. Do you have the facility to really find out what their terms are?

Mr. Draper. Well, many of these are international bids, and they are open to the public; and the buyer, of course, has no reticence to make it well known if he has got a better interest rate than yours.

Chairman Gibbons. He can shop around and get a better deal, is that it?

Mr. Draper. Any purchasing agent has the same kind of a reaction. They often just try to play one off against the other. That is the reason it ~~has not~~ been to anybody's benefit. Actually, among all the countries, the leading countries, the leading five countries in the OECD that we compete against most, the only one that has increased its market share has been Japan. The other countries, like ourselves, have lost market share; and our relation to each other has not changed at all with that exception.

Chairman Gibbons. Do you detect on the part of other governments a feeling that they want to put an end to the silly kind of warfare that we are carrying on in the export financing area?

Mr. Draper. Do I detect what, sir?

Chairman Gibbons. You perhaps have already answered part of this, but I want to keep driving on this question, because I think one of the big areas in international trade that we constantly do not look at is the financing arrangements. I know that there is a gentlemen's agreement in the OECD about financing terms, but I think it is only generally honored.

Maybe you would like to observe, is it only generally honored, or is it honored? How often is this agreement honored?

Mr. Draper. Well, I think the agreement is honored the vast majority of the time. Where we run into a problem is in mixed credits where they bring in aid. Of course, we encourage any country to put up as much aid as possible for humanitarian reasons. But on the other hand, what they have done is to tie it in with the sale of an export, and they have shaded the interest rate just enough, given enough aid to bring the interest rate low enough, in order to buy the order or buy the business.

And that is an area that is covered in this agreement, and there are certain ground rules, but they are not quite tight enough. We are trying to tighten them up and raise the threshold from 20 percent aid portion up to higher, let's say 30 percent, which would make it that much more expensive for them to put aid into the package as a mix.

But generally, I think the answer to your question is these countries are showing a lot of willingness to examine the causes of their inflation. And France has been slower to recognize the impact of this on their economy. They are a socialist government, and they act that way. England has gotten more responsive in recent days. Germany does very little of this. They usually guarantee loans. They do not make subsidized, direct loans to their businesses. And Japan has very low interest rates so they do not have to cut their interest rate in order to be competitive.

Now, we have a system that we have put into the Eximbank where we will guarantee a foreign currency so that when the Japanese salesman for Komatsu goes out and sells to Indonesia, they can offer, say, 8.4 percent interest. Our salesman from Caterpillar can go right alongside him and offer the same interest rate in yen. And we will guarantee the bank that puts it up, whether it's the Chase Manhattan or the Bank of Tokyo. If they put up the yen, we will guarantee that they will get repaid in yen. So we do have a competitive tool there.

But overall there is always a desire on the part of some governments, particularly when the head of state travels to sell some products, and they offer a very low financing deal that it is difficult to combat. But now these rules really have brought people into line in the vast majority of the cases.

Chairman Gibbons. Well, you obviously know far more about this than I do. But let me say what little I know about it leads me to believe that we still need to do a great deal more, because this is the ultimate form of subsidy; and we seem to have no system of controlling it. We have got a gentlemen's agreement through the OECD, and the OECD is a fine institution. I just have a certain amount of skepticism about gentlemen's agreements. I would like to get something that is stronger than a gentlemen's agreement, but frankly, I cannot describe what I think we need.

Mr. DRAPER. Well, really, the one you are referring to is the aircraft loan.

Chairman GIBBONS. That is not the only one.

Mr. DRAPER. But the OECD agreement is a consensus. It is a written document. It has been agreed to by all Ministers of Finance, and is not just for gentlemen, or there would be several that would not be involved.

Chairman GIBBONS. Let me ask you about our Export-Import Bank. When you agree to participate in a sale, do you have a mechanism within the Bank of looking at the possible impact it has on other American industries? Let me give you an illustration.

You have someone who is selling machinery abroad, and that machinery is to be used abroad to manufacture some hypothetical thing like a widget. Do you look at what impact that would have upon the widget manufacturers in this country when you agree to help promote the sale of machinery that is to manufacture widgets abroad? Is there some definite procedure that you follow?

Mr. DRAPER. Yes, sir. We have a vice president of policy analysis, and under his wing there is a study done every time we have anything that might impact unfavorably on our own economy by supporting an American export. He does what is called an impact analysis, an adverse impact analysis which is a written piece of paper that very often is presented to the board before they make the decision that strictly deals with the impact on jobs and the economy. So that if the widget manufacturers in this country were employing more people or would lose more jobs because of the competition developed in the foreign country by a new widget manufacturer, why, would we not make that loan and not help that company abroad buy American equipment.

Now, a lot of times the case is difficult because some foreign buyers might have other foreign companies to buy the same equipment from and with very strong financing to support them. So we look at that and consider the possibility that the plant might be built anyway, in which case we would be at a disadvantage of losing not only the jobs if we did not support it for the equipment that went overseas, but we would also lose the jobs anyway because that plant was going to be built.

So we do analyze that, and we try to take a good, hard look at it and make sure that it makes a lot of sense before we get any Government financing involved.

Chairman GIBBONS. Is the American widget manufacturer, and perhaps his labor, able to, one, know that such a loan is about to take place, or, two, have any hearing or input into the information that is gathered or the collection of this?

Mr. DRAPER. Yes, sir. We have a constant conversation going back and forth between many of the associations that represent a variety of manufacturers of different kinds of products, and we constantly search for their opinions and any knowledge that we did not have in preparing this adverse impact report.

Chairman GIBBONS. Well, is this an informal thing, or is it done under regulation, or how is it carried out?

Mr. DRAPER. It is not a formal thing, but it is very aggressively sought; and, in fact, you and I both know about the concerns we both have that we are not adversely impacting employment due to loss of sales of competitive phosphate production equipment in Morocco where they have been a customer of ours for capital equipment. Phosphate production down in your part of the world is important, and you have talked to me about it, and we have sought that out. And, in fact, I think it is next week I am meeting with the Fertilizer Institute, and we are very——

We had the president of IMCC in about 3 weeks ago. I mean we are very sensitive to the problems.

Chairman GIBBONS. I ask you these questions because I am really not familiar with your procedures. I realize that you respond to inquiries I make over there, but I am worried about the broader picture; and that is, the whole process of assessing the impact inside and outside the country. I do not know the procedures.

Mr. DRAPER. We make a very thorough analysis to make sure that there is no adverse impact of the financing that we make available.

Chairman GIBBONS. Do my colleagues have any questions?

Mr. JENKINS. Mr. Chairman, I am not very familiar with all of the activities of the Eximbank. As I understand it, part of your activities include the guarantees of commercial risk undertakings. I remember having some correspondence 2 or 3 weeks ago from a carpet constituent that was doing business in Venezuela. He was having difficulty getting reimbursed. As I understand it, the Eximbank was reimbursing, on a commercial risk basis, claims from Venezuela. You did that as a standard policy, even though he was contending that he ought to be reimbursed on a political basis. His customers were actually paying into the bank in Venezuela. He could not repatriate those funds. It ended up that really he was only getting 90 percent of invoice price. He could not understand that.

Now, is it standard policy as to Venezuela?

Mr. DRAPER. That is the standard policy as to Venezuela. If the government guarantees it or if it is a government-owned agency that purchases the carpet or any other equipment, we cover 100 percent of political risk. And if it is a commercial transaction not guaranteed by them, by the government, we will cover 90 percent.

So your example is a case where they did not get paid in Venezuela, and they applied to us for a claim. And, of course, one of the fastest growing departments in our Bank is our Claims Department, because Mexico, first, and then several other countries have brought about serious problems for many of the commercial companies down there.

But there is a distinction between Mexico and Venezuela. Mexico was a very abrupt change where, within a space of a few months, the peso went from 20 to 150 to the dollar. There has been a gradual erosion on Venezuela, and the problems there have become more serious recently, and the government attitude is difficult. We are working with them to try on behalf of many of our clients to try and get their policies opened up and broadened.

But we do not see it. It is not a currency transfer risk, which is what you are talking about, in our opinion. And we have acted exactly the same way for all clients that we have in Venezuela.

Mr. JENKINS. Is it only in Mexico that you reimburse on a political rate?

Mr. Draper. Yes, sir, we do. In Mexico, it was such an unusual circumstance; it hit so fast. They nationalized the banks. They refused to allow currency to leave the country—foreign currency. And in Venezuela's case, all of those things did not happen that suddenly, and they do have a system where the companies can find foreign currency in order to pay their debts, and some are doing it; some are not. And those that are not, we are paying 90 percent, but we are not paying 100 percent.

Mr. Jenkins. Why would it be a commercial risk if in fact the purchaser there is paying into a bank the entire amount, but he still cannot get his funds. It would appear to me that would be a political situation, not a commercial one.

Mr. Draper. Well, if they have paid the entire amount, then I do not think we would have a problem, because if they had paid the entire amount, we could get the dollars out—now, not at 4½ pesos or bolivars—I have forgotten the currency there.

I will tell you this. We have a team that is going down to Venezuela to discuss these very problems and to try to figure out what can be done to help release currency. But the difference really is in the suddenness with which the Mexican thing occurred. People were just frozen and so were the rates they were charged for their supplies. For example, if you are in business and you are charged at a certain rate for your supplies and price your product at a certain rate, and you know there is inflation that is increasing all the time, you increase your prices accordingly. But when it all happens within a space of a few months or there is a major announcement of a nationalization of the banks and so on and a freezing of all foreign currency, as happened in Mexico, you found that the prices you paid for your product versus the prices you are charging for the final product are so out of whack that you are out of business.

And that is why we were paying full political risk in Mexico. It is a unique situation. It is the only country we have done it in.

Mr. Jenkins. It is the only country that you are paying 100 percent? All of the others at 90 percent, is that correct?

Mr. Draper. Right. Unless it is guaranteed by any government, in which case we do pay 100 percent.

Mr. Jenkins. So Venezuela is not an exception?

Mr. Draper. No.

Mr. Jenkins. Normally, is it made known to these exporters here that they are only looking at the possibility of 90 percent reimbursement?

Mr. Draper. Well, yes. That is the way the policy is written.

Mr. Jenkins. It is?

Mr. Draper. Oh, yes. They are protected against political by devastating action, which we consider happened in Mexico, but we did not consider it in Venezuela.

Mr. Jenkins. The largest percentage of your budget I understood you to say is going into certain heavy equipment capital—aircraft, transportation, that type of thing?

Mr. Draper. Yes, sir.

Mr. Jenkins. About how much of it goes into that category of your total budget?

Mr. **Draper**. Well, over the years, about 25 percent has been in the transportation area and 25 percent in power, and the balance has been spread over a variety of other equipment.

Now we are doing more satellites, for example, but we have had locomotives and equipment. We have financed a semiconductor plant in Israel. We have financed equipment for mining projects, tractors, just all over the map. But we are doing a little more in straight agriculture financing now and short-term insurance programs; and that has been brought about because of the resource shortage of the Commodity Credit Corporation. The budget there is tight. And where we only make 1 year available, they make 3 years available on financing, and theirs is a much more attractive program. It is a very strong program.

Mr. **Jenkins**. I have heard a lot of complaints from the broilers, the chicken industry. Its market in the Middle East has been replaced primarily by subsidized exports out of Brazil, and to some degree France, and some of the others areas.

Are you doing anything that you are aware of to help our own broiler exporters to try to compete?

Mr. **Draper**. Well, as I say, Brazil is not a member of the OECD, so that we are trying to get them to abide by the OECD minimum requirements. So when they compete, it is very difficult to say that we are matching them. We are not sure what they are doing sometimes.

But with regard to chickens, I remember a case just recently where we have financed a very automated kind of poultry equipment that was being used over in I think it was the Middle East.

Mr. **Jenkins**. Why would you be financing the installation of a broiler operation in the Middle East to compete with the domestic industry here?

Mr. **Draper**. Well, here again, that is where this adverse impact comes. In other words, there is equipment that goes overseas and it is used there. They are not buying from us in great quantity. If they were and it had an adverse impact on the poultry industry here, we certainly would not do it.

I think in that particular circumstance there was a need for food and development of their own industry, and so we went ahead and did it. So it varies. The approach would vary depending upon the economic impact on the United States. We have only one goal, and that is to help the American exporters and the American industry. We are not doing it on the basis of aid for a foreign country. That is clear.

Mr. **Jenkins**. We have so much broiler production in this country. It would appear to me it would be in the best interest of the Eximbank if you want to help American exporters with the exporting of the broilers rather than the facilities for them to compete.

Mr. **Draper**. Sure. And we might well, and we have these insurance policies like the one you were just mentioning in Venezuela where we do not even know what the products are—and many of them undoubtedly are broilers—that are going abroad, that are covered by our insurance, and that enabled U.S. exports to be protected in case they do not get paid by the buyer.

Mr. **Jenkins**. The reason I bring this up is that I did have an inquiry from a broiler exporter that said he could not believe that the Eximbank would actually be financing the construction of broiler operations in the Middle East.

Mr. **Draper.** Well, this is exactly the point that the chairman was making. There are calls that are difficult sometimes where a new industry in a foreign country might compete with an industry that is already established in this country.

Mr. **Jenkins.** My people have never had the opportunity to come in and discuss this with the Eximbank.

Mr. **Draper.** Well, I would welcome that.

Mr. **Jenkins.** Do you have a process now that they would be notified when you are thinking about making such a loan?

Mr. **Draper.** Well, we do not have a formal process, but yes, we have talked to that industry a number of times and made very clear the kinds of policies that we have and where their concerns might be taken into mind.

Mr. **Jenkins.** I think the complaint that they have is that they learn about it after the fact. They for some reason resent feeling that they are paying for the creation of competition.

Mr. **Draper.** Our agenda is public. I mean it is a public agenda. We make it ahead of time. So that is not fair criticism.

Mr. **Jenkins.** Do you publish your agenda in some document?

Mr. **Draper.** Any association, say the poultry dealers or whatever, can find out what is in our agenda ahead of time. I mean we do not go around and try to find every poultry dealer in the country and tell him what we are doing next week, but we do make it available so that associations can alert their people if they want to discuss it ahead of time.

Mr. **Jenkins.** Is there any way the associations could tie into a notice that would be sent out to anything dealing with broilers? Or to carpet? Could associations ask to be placed on your mailing list, or do these agendas come up on short notice?

Mr. **Draper.** Well, very often they are under study for a number of months ahead of time before they get prepared and put up before the board. But we do not try to put it in all of our mailers, because we have hundreds and hundreds and hundreds of cases that we are taking up all the time.

I think the best thing I would suggest, Mr. Congressman, is to have them come in to see us and let us talk about the procedure and what points they might have. If you would like, either I can initiate it from our end, which I would be happy to do, or you could initiate it with those that you know who are interested.

Mr. **Jenkins.** I receive those complaints rather constantly. They really do not seem to know when you are going to take up something so that they can register their concern and their opposition in many cases. It seems to me that we ought to have better knowledge and the general public ought to have better knowledge of the agenda.

Chairman **Gibbons.** Well, of course, Mr. Jenkins, that is what I was driving at with Mr. Draper a while ago. The Bank has always been very cooperative. I just do not understand exactly how public all of this is and how much of it is confidential. That was what I was trying to find out.

Mr. **Draper.** Well, it is not confidential. It is publicly laid out.

Mr. JENKINS. If you could put me on your mailing list for an anticipated actions in broilers or textiles or carpet, I would appreciate it.

Chairman GIBBONS. That might be a hell of a burden for him to have to carry, because that is a complicated thing. I do not know how we have to do this.

Mr. Guarini.

Mr. GUARINI. Thank you, Mr. Chairman. Just a few questions.

Considering the generosity of the financing and the state of the debtor nations that you are dealing with all the time, just how big, Mr. Draper, is your loss factor in these loans that you are making? It certainly would be more than a regular banking organization could expect as a loss factor, is it not?

Mr. DRAPER. We have reduced our delinquencies, our loan arrearages, substantially with a collection of $420 million that we have been wrestling with. I ran over, and we accomplished that this past year after 2½ years of negotiation. But currently our arrearages as of January 31, 1984 are $712 million.

Mr. GUARINI. Did you use the same accounting procedure that is accepted by domestic banks?

Mr. DRAPER. Well, we do not write off where we have made a loan and it has gone to a country in difficulty; let us say we reschedule and it becomes a purchase of assets. So that we do not take exactly the same——

Mr. GUARINI. So it is all a matter of how you keep your bookkeeping. The numbers can do whatever you want them to do.

Let me ask you how much in loans do you have outstanding right now on the bank?

Mr. DRAPER. $17 billion, approximately.

Mr. GUARINI. $17 billion.

Now, when you made your budget request, were you cut very much this year, or do you have what you asked for from the administration?

Mr. DRAPER. For 1984, we have a budget that is just about what we asked for. It is very close to what we asked for.

Mr. GUARINI. Are you still financing factories being built in foreign markets such as the steel plant in Korea, which is, of course, counterproductive because it is causing competition with our own people and taking jobs away from our own American citizens.

Are you still doing that?

Mr. DRAPER. We had a very difficult case in Korea that came up, and it was interesting because the Commerce Department wanted us not to do it, and the Treasury Department wanted us to do it, and which is sort of a reversal of roles.

Mr. GUARINI. Who do you listen to the most?

Mr. DRAPER. Well, we vary depending upon the case. We take it case by case, and we try to look at the facts and the advice, and then come to a judgment with five board members in their best judgment.

Chairman GIBBONS. But the State Department has an extremely large input into all of the decisions that are made and the banking process?

Mr. DRAPER. The State Department does, too. We have a National Advisory Council that is made up of a number of agencies, and they all give advice. But in the Korean situation, that was a $2½ billion project, and the only financing that we made available was on a guarantee basis to Dravo and Air Products who were part of a large combine that was bidding on the process. And because they were exporting American equipment, we made a guarantee available; but we did not make any subsidized financing available. We did not make a direct credit, for example, in Korea. The rate is set at 10.7 percent.

Mr. **Guarini**. However, now our steel industry is looking for an import quota for 5 years in order to protect itself because Korean steel is undermining our own American market. Does that sound counterproductive to you from an economic viewpoint?

Mr. **Draper**. No; not what we did, because—in fact, I talked with the Iron and Steel Institute about it, and they thought we had done the right thing. I talked to the president of Dravo about it. He was pleased we had given him a fair shake, and but we had not given any subsidy. And as long as there is no subsidy of a product like that, we have not given anybody any problem.

Mr. **Guarini**. From your experience in the world market, what would you give as an observation or a recommendation to this committee as to the problem we have with the hard dollar and the resulting imbalance of trade. What positive suggestions could you give to the committee from your observations?

Mr. **Draper**. My suggestion would be that you cut back Government spending dramatically.

Mr. **Guarini**. In defense?

Mr. **Draper**. If you could reduce the deficit, the dollar would reach a more normal level, and the real interest rates would not be as high. People would not perceive our management as being bad, Government management; and therefore, the dollar would come down. This would help American exports be more competitive, and it would help American industry have fewer taxes to burden them when competing. And I think that is the key to the whole thing.

Mr. **Guarini**. Other than governmental action is there any action to be taken by the other segment of our society?

Mr. **Draper**. Well, I think the working together with labor and management, which has been brought about in recent years because of crises in various locations around the country caused by unemployment and so on, and the need to close plants and what have you, and the desire for everybody to keep those plants open and keep that employment going, is paying off as it did in the case of Chrysler, for example. And, of course, the Government involvement there in hindsight was a good move.

There is a theoretical argument that the funds used that were guaranteed by the Government might have been used in other industries perhaps more productively, but I think certainly in the short run that was a very good move.

I think you have the need to develop more investment incentives, which again means a reduction of, say, capital gain taxes, encouragement to invest in research and development, the encouragement or the ease with which a man can leave one industry and move into a more growing industry—those are all aspects of the economy which make it more fluid so that we are producing the most efficient products that we know how to produce, and we are doing it most efficiently as compared to other countries who might make some products better than we do, and let them have that territory. I would be for those various aspects.

Mr. GUARINI. Thank you, sir.

Chairman GIBBONS. Mr. Draper, I want you to think about this. I have not thought about it very much, but I want you to think about it.

This committee is undertaking a rewrite of some of our basic trade laws, and this year we are looking at the impact of subsidies and dumped goods in our own market. One of the things that constantly worries us is that subsidies and dumped goods take away the market of American exporters or legitimate American business people in third markets.

All we have now is a negotiating authority in which we may try to negotiate this away. I am thinking about something that would give to you or a bank like you, after the appropriate findings that a subsidy was taking place and it was taking legitimate American exports away, the authority to go in there and to meet those subsidies, meet and beat those subsidies. I have the feeling that once we deliberately enter into that process, we are going to put an end to the kind of subsidies that take our market away.

And I want you to think about how that could work, because you have had much more experience in that field than I have. But I think the threat of meeting or beating subsidies in third markets by the use of a bank like yours or your bank would be the way to give some urgency to the negotiations that are supposed to take place about subsidies to third markets.

I do not have a proposal, but it is something that I would like to sit down and talk with you about. Perhaps next year we will have a proposal, and perhaps next year we can talk about it even more. But I would like to have you and your agency think about how it could be done.

Mr. DRAPER. All right. We will. We do have authority and in fact instructions to have a mixed credit program that would—so that we would meet some of these subsidies that are occurring. But it is difficult because our AID operations are primarily for humanitarian reasons or applications, and they are, therefore, not being used in these mixed credits. And it is difficult for us to do the job without them in a thorough way.

The other point I would make, though, is a caveat. You know, you have a country like France. They are a socialist country. They will just stupidly dig deeply into their pockets and right through the hole in their pocket will pour all of the funds from the top of the treasury, and it just is an escalating thing. And it is very evident that their interest rates have grown and their inflation rate has grown so dramatically in recent years, and ours has come down dramatically. Ours has gone down to 3.8 percent in 1983, and theirs is up around 12 percent, I believe.

Chairman GIBBONS. Yes. I do not want to get into that kind of useless subsidy. I want us to put an end to the subsidy practices as best we can. And unfortunately right now, we have international agreements that prohibit subsidies, and international agreements that are supposed to work. But they are painfully, painfully ineffective and slow.

And what I am looking for is something—not something this year because, as I say, we have not thought about it enough. We are going to try to take care of the domestic market this year and look into third markets next year. But I am looking for something with the appropriate finding and the appropriate limitations on it that we can use when we find a country subsidizing its product into a third market; a mechanism so that we could just go out and quickly with the appropriate resources bring this kind of practice to a halt. There would have to be some findings, and there would have to be some deliberations, and there would be some hearings and all those other things before we jumped into that; but when we did jump into it, we would jump into it with enough force to do something about it—I should not say force—but enough—well, force to do something about it.

Mr. **Draper**. We did meet recently two very low-priced offers, both by the French, one for a Cyprus sale of telecommunication equipment, and one to Indonesia, which is sophisticated machine tool equipment from Cincinnati Milacron. And in both cases we met their lowball financing, but more on a rifle-shot basis.

Chairman **Gibbons**. I want the rifle-shot basis.

Mr. **Draper**. Because on a massive basis, it is very difficult. For example, just recently, Nakasone of Japan went over to China and offered another $2 billion of low-aid money to develop their resources in China, but their main interest is in, let us say, coal or some of the minerals out of there. And part of the tie-in is that they will get the coal production.

Well, of course, in this country that is not our need. We do not need more coal in this country. So there are different reasons why you might meet certain subsidized financial aid, and sometimes when you would stand away from it and not touch it.

But I agree with you 100 percent, Mr. Chairman, that we have got to somehow through negotiation, the carrot or the stick or whatever, bring about much more uniform understanding of the costliness of the subsidies to all countries.

Chairman **Gibbons**. The trouble is that now when we enter into these negotiations, we have neither carrot nor stick. We just enter into the negotiations. The other side knows that if we are going to do anything about it, it will be so disastrous to some of our other industries that we are not going to do anything about it, and so the subsidy goes merrily on, and we lose that.

We are not going to put an end to all subsidies. There would have to be subsidies that are injurious, there would have to be subsidies that are controlling, and it would have to be, of course, in the national interest that we do this.

Mr. **Draper**. But in the last 3 years, we have reduced the subsidy about 80 percent in this total area just through these negotiations and through this understanding that we have. So you are right: it is never over until it is over. But a lot of progress has been made.

Chairman **Gibbons**. Well, good. Fine. Thank you. I thank you very much.

This concludes our hearings for today. Tomorrow we will meet at 9 a.m. in this room, and we will have Mr. Feldstein, and after him, Mr. Sprinkel, and then at 2, Mr. Baldrige. And we are expecting—we have tentatively scheduled the Honorable Paul Volcker, the

Chairman of the Federal Reserve System, for April 10 in the morning. And there will be more details put out as we go along.

Thank you very much for attending.

[Whereupon, at 12:30 p.m., the subcommittee was adjourned, to reconvene at 9 a.m., Thursday, March 29, 1984.]

U.S. TRADE DEFICIT

THURSDAY, MARCH 29, 1984

House of Representatives,
Committee on Ways and Means,
Subcommittee on Trade,
Washington, DC.

The subcommittee met at 9:10 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Sam M. Gibbons (chairman of the subcommittee) presiding.

Chairman Gibbons. Good morning, ladies and gentlemen. As everyone knows, this is a meeting of the Trade Subcommittee of the Ways and Means Committee in which we are discussing the trade deficit.

We are trying to find out where we are in this big economic picture, how we got here, where we are going, and what action we should be taking for the future. We have our eyes fixed, of course, on the merchandise trade deficit, what it has done to the factories and farms of America and the people that work there.

Yesterday we started with Ambassador Brock and with the administration. Today we have the Chairman of the Council of Economic Advisers, Mr. Martin Feldstein.

Mr. Feldstein is no stranger to this committee. He has been here as an adviser, both during and prior to his Government service, in and out of Government service. And we welcome you back.

After Mr. Feldstein, we will have Mr. Beryl Sprinkel of the Treasury. And at 2 o'clock this afternoon, we will have Secretary Malcolm Baldrige.

It is our purpose to gather as much information and put as much in the public arena as we can concerning the U.S. deficit in the merchandise trade area, and, of course, in the current account area also.

We are seeking information. I want to say to the public that is here and for the record, we had a very informative breakfast that started at 7:45 this morning with Mr. Feldstein, and he is practically exhausted from that better-than-an-hour discussion that we had; but we want to hear more now. So we appreciate it and you may proceed as you wish.

STATEMENT OF HON. MARTIN FELDSTEIN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. Feldstein. Thank you very much, Mr. Chairman. It is always a pleasure to appear before the members of this distinguished committee. I welcome the opportunity to comment here on the problem of the exchange rate and on our trade imbalance.

I have a brief statement that I will read and I will be happy to answer your questions.

Chairman GIBBONS. All right, sir.

Mr. FELDSTEIN. Let me say first, however, that I am terribly disturbed that Members of Congress are even contemplating the imposition of a new discriminatory tariff. A tariff increase can be a sure-fire way to undermine our fight against inflation and to weaken the long-term competitiveness of American industry. A new tariff would hurt American consumers directly and would hurt those American firms that use imported machinery and materials. And a discriminatory tariff would run counter to the basic spirit of American trade policy and of our international treaty obligations. I will comment specifically on the committee's question about the appropriateness of invoking section 122 of the 1974 Trade Act to justify such a change in trade policy.

One: The United States is experiencing a very substantial merchandise trade deficit. Our merchandise trade deficit rose from $36 billion in 1982 to more than $60 billion in 1983 and is expected to exceed $100 billion this year.

Indeed, within the last hour, the Commerce Department announced the merchandise trade deficit figures for February. For the first time, the United States had a 1-month merchandise trade deficit at the double-digit level of $10.1 billion, the merchandise trade deficit for February.

That reflected declining exports and occurred even though there was some fall in imports, though it was exclusively on the export side to move from January $9.5 billion merchandise trade deficit, which itself had been a record, to this morning's $10.1 billion trade deficit.

A trade deficit of this magnitude represents a serious problem for American exporters and for those American firms that compete with imports from abroad.

Although real exports actually rose by about 5 percent during the first year of the recovery, the level of real exports at the end of 1983 was 10 percent below the economy's previous peak in 1981. As I said, it fell again by about 6 percent annual rate in this morning's figure. By comparison, after a year of recovery during the past business upturns, the level of exports had generally surpassed the previous peak. The reason for the difference is that exports fell nearly 15 percent for the period between the business cycle peak in 1981 and the cycle trough in 1982. By comparison to past recessions, the export fall in past recessions averaged less than 2 percent.

Two: The primary reason for the poor performance of exports in recent years has been the rise in the value of the dollar. The increased trade deficit does not represent any loss of fundamental competitiveness by American firms. Part of the decreased trade deficit is cyclical, reflecting the more advanced recovery in the United States than in other major industrial nations. Another part of the current trade deficit is due to the reduced demand for imports by the LDC debtor nations that can no longer finance their previous volume of imports. But the major cause of this year's increase in the trade deficit—somewhat more than half—is due to the 50 percent rise in the real value of the dollar that has occurred since 1980.

Three: The trade deficit problem will eventually correct itself. The rates of economic expansion in the United States and in other industrial countries will be closer in 1984 than in 1983. The import capability of the debtor nations will also improve with time. And the dollar will decline toward a level that is compatible with the approximate balance of our current account. Note that in saying that the dollar must come down I am not saying that the dollar is overvalued in any fundamental sense. Overvaluation is a meaningless term in discussing a price like the exchange rate that is set in the free market. When exchange rates were fixed, it was possible to talk about overvaluation; overvaluation then meant that withdrawing Government support for the currency would cause the dollar to fall.

But although overvaluation is not a helpful term, it is clear that the dollar is currently above its sustainable value. The dollar is above the level that is consistent with an approximate balance of the current account.

Although the speed with which the dollar will move toward a sustainable level cannot be anticipated with certainty, we have already seen a dollar decline of about 5 percent from its high earlier this year.

Four: It is important to recognize, as I was saying during our breakfast meeting, that there are advantages as well as disadvantages of the merchandise trade deficit under current conditions. The trade deficit entails a capital inflow that adds to the pool of investable funds in the United States. This year, the expected net capital inflow of about $80 billion will be enough to finance about half of all net fixed investment in the United States. Note that I have referred to a net capital inflow of $80 billion. It is the net capital inflow that adds to the pool of investable funds in the United States. The net capital inflow is the difference between the gross inflow of funds from abroad and the gross outflow of investment from the United States. The division of the net inflow between the gross inflow and the gross outflow is basically irrelevant and cannot be predicted. All that we can say is that the relative attractiveness of investing funds in the United States determines the net inflow of capital. I emphasize all of this because there has recently been some careless discussion that focuses on the gross capital inflow and therefore confuses the nature of the capital inflow relation.

A large net capital inflow is particularly helpful now because the budget deficit currently absorbs more than half of all net domestic saving. That is another reason why I do not like the expression "overvalued." Given the large budget deficits, it is useful to have the international capital flow as a safety value. Without it, real interest rates would be higher and investment lower.

Let me just emphasize that what I am saying is that a drop in the dollar would imply a rise in real interest rates. There is some confusion about that.

One hears discussion about a paradox, which is that, on one hand, high interest rates cause the dollar to be strong, but at the same time, a fall in the dollar would cause interest rates to be higher. One correlation is positive and the other correlation is negative, but there is really no paradox in that at all.

I would explain it in the classroom as being analogous between the relationship of the quantity of fish that fishermen catch and the price of fish. If the price of fish goes up, the fishermen will work harder to catch more fish. If for some reason, they bring in a big catch one day by luck, that will depress the price in the market. So it all depends on where the impetus comes from.

In terms of the dollar and interest rates, when real interest rates in this country move up that tends to strengthen the dollar. But if there is some autonomous drop in the value of the dollar, that pushes up interest rates.

So there is no paradox in the fact that, for example, we have recently been seeing a dollar that has come down a bit and at the same time interest rates are rising. It just tells us where the impetus is coming from. It is coming from the fall in the dollar and having effects on interest rates rather than the other way around.

Five: What I have been saying about the positive effects of a trade imbalance implied that reducing the trade imbalance by any type of trade intervention—including quotas, tariffs, or policies to discourage foreign investors—would have adverse effects on our rate of domestic investment. Such effects could be particularly unfortunate when, as now, the net investment rate is unusually low. It would be far better if the reduction in the trade deficit and capital inflow accompanied a decline in the budget deficit and therefore in the Government's borrowing. The reduction in the Government's demand for funds would then at least balance the reduced supply of funds from abroad.

Six: There are other more specific reasons for opposing the type of tariff contemplated by section 122 of the 1974 Trade Act. Although I am not a lawyer, it seems to me that imposing a tariff on imports from a single country would be in violation of our treaty obligations under GATT. Such a discriminatory tariff would certainly run counter to the most-favored-nation concept that has been a fundamental principle of U.S. trade policy and of the postwar liberalization of trade throughout the industrial world. Furthermore, any tariff increase, whether focused on one country or more than one country, would run counter to all of our Nation's statements about the virtues of expanded world trade and the dangers of increased protectionism. The imposition of such a tariff by the United States could easily start a series of retaliatory actions that develop into a destructive trade war.

Seven: The immediate effect of a surcharge would be to penalize not only foreign producers but also American consumers. Prices of the surcharged goods would rise, putting upward pressure on the overall price level.

We are beginning to hear more and more comment and concern about inflation these days. Certainly, any return to the inflation experience of the late 1970's would be terrible. A sound monetary policy is the key to sustained progress on inflation. But tariffs and other forms of protectionism are a surefire way to raise prices. A tariff raises the price of imports directly and encourages American producers to raise their prices and wages. And a quota that limits imports raises the price that those products sell for in the American market. Moreover, with the higher price and greater scarcity of imports, American firms that make similar products will charge higher prices and pay higher wages.

Eight: At a more technical level, section 122 appears not even to apply to the current situation. The specific language of that section provides for the imposition of a tariff surcharge "one, to deal with large and serious balance-of-payments deficits" and "two, to prevent an imminent and significant depreciation of the dollar in foreign exchange markets * * * ".

Although we have a trade deficit and a current account deficit, we do not have, technically speaking, a balance-of-payments deficit of the type envisioned in section 122. The technical definition for the balance of payments is the rate of accumulation of official reserve assets or goals. Since net U.S. sales of assets to foreigners in 1983—in other words, our current account surplus, the private investments by foreigners here—is more than enough to offset the U.S. current account deficit, official U.S. reserves actually increased. Thus, the United States had a balance-of-payments surplus. Although the current account deficit will be larger in 1984 than it was in 1983, there is no reason at this time to expect that there will be a balance-of-payments deficit in 1984.

It is clear also that a tariff surcharge cannot be justified to prevent an imminent and significant depreciation of the dollar in foreign exchange markets. The dollar is most likely to decline by a few percent during the remainder of 1984. Since the dollar is a volatile asset price, it is also possible that there will instead be either a rise in the value or a more significant decline. But there is no reason to believe that a significant depreciation is imminent at the time. Moreover, under current conditions, very low savings rate in the United States and borrowing, there is no reason to try to prevent such a decline.

Nine: The appropriate remedy for the present trade deficit is to reduce the deficit in the Federal budget. In saying so, I do not wish to imply that the budget deficit is the sole cause of the trade deficit. But it would clearly be unwise to try to reduce the trade deficit by slowing our recovery or by weakening the dollar through inflationary monetary policy or through statements aimed at undermining the political safe haven character of the American economy. By enacting the substantial deficit reduction downpayment package recently proposed by the administration and the congressional Republican leadership, it should be possible to move simultaneously toward a more competitive dollar and lower cost of capital in the domestic economy.

Thank you, Mr. Chairman.

Chairman GIBBONS. I appreciate your statement, Mr. Feldstein, and I think it is a good summary and reflection of my beliefs.

My beliefs come mainly from instinct and not from training or from any preconceived ideas. But in effect you are saying that while we are measuring trade deficits and concentrating our attention on that, there are other things that we ought to be looking at. There are many effects of this deficit.

One of the effects of this deficit is to make it easier on other segments of the American economy to adjust to the kind of changes they would have to make in this environment.

I don't want to put words into your mouth, but as I see it, if we took action, and I don't anticipate that we will, but if we took action such as the surcharge or some drastic tariff changes to immediately change the trade deficit, in effect housing would become more expensive, unemployment in other segments of the economy would greatly increase, and generally America would be in a great deal more pain and in a great deal more financial stress than it is, even running the kind of deficit we are running right now.

Am I correct?

Mr. FELDSTEIN. Yes; we would be in effect shifting the locus of pain within the American economy, putting more stress on the financial system; higher interest rates here as a result of this.

Chairman GIBBONS. Do you anticipate that there will be any turnaround in this merchandise trade deficit that we are running?

Will there be a dropoff in the trade deficit considering the factors today as best we can measure them? Will there be an increase?

Can you speculate—and I am asking you to speculate now—where we are headed?

Mr. FELDSTEIN. You have to distinguish where we are headed in the near term from what will happen in the more distant future.

In the more distant future, we have to move back to a position of rough current account balance, perhaps even current account surplus as we start to finance the large international debt that we as a country will accumulate over the next few years.

But if you ask what is going to happen in 1984 or 1985, I think this year we are almost certain to have more than $100 billion merchandise trade deficit. Looking to 1985, I think that again we are likely to have in 1985 a $100 billion merchandise trade deficit unless there is a very sharp fall in the value of the dollar in the next few months.

Chairman GIBBONS. Your recommendation to this committee would be to not take any affirmative action at this time in any way to seriously change our trade balance; is that correct?

Mr. FELDSTEIN. I would recommend, as I did in the last part of my remarks, moving ahead as quickly as possible to deal with the federal budget deficit but avoiding acting directly in the trade scene.

Chairman GIBBONS. That is what I mean. Big emphasis has got to be in the U.S. domestic fiscal deficit and not in changing our fundamental trade laws radically so that they impact upon that red line we see over there to your right.

Mr. FELDSTEIN. That is correct.

Chairman GIBBONS. Frank, do you have questions?

Mr. GUARINI. Yes, Mr. Chairman.

Every person I talk to talks about the deficit and the need to get it under control. I agree with this, but it seems to me that there are many other areas that we could look into, such as raising productivity and helping to restore a sound economy, than just looking at the numbers or the deficit itself.

First I would like, if you could spell out as a professor the difference between the Federal deficit and our trade deficit and how one is connected with the other. Is there a relationship you can develop there?

Mr. **Feldstein**. Yes. There are different ways of saying the same thing but basically the large Federal deficit creates a demand for funds in this country and sucks in resources from the rest of the world. It creates a kind of vacuum in our capital market that sucks funds out of the rest of the world and keeps our funds in this country from flowing abroad as much as they might otherwise do.

The mechanism by which that happens is an increase in the real return on debt and equity investments so that those investments look more attractive to foreign investors and that attracts those funds to come here.

Mr. **Guarini**. Is the IMF doing just the opposite.

Mr. **Feldstein**. You have to ask what would happen if you did not have the current IMF programs. I think the IMF programs have, in the case of Brazil, for example, made it possible to keep the banks in and lending and avoiding the kind of total collapse of financial and trade relations between Brazil and the rest of the world that might otherwise have occurred.

It was the banks' sense that the IMF had gone in and worked out an appropriate policy with the Brazilians and they can monitor that, a kind of Good Housekeeping Seal of Approval that the IMF provided led to the financial transfers to Brazil and kept Brazilian imports as high as they are.

Brazilian imports would have come down a lot without a program of the sort that the IMF worked out and without the kind of lending that has come both from private sources and from public sources like the Export-Import Bank. The Brazilians would have contracted their economy much more and probably been forced into default.

Mr. **Guarini**. Would you advocate any changes in the policy of the IMF or do you think that they are necessary as they are in place now?

Mr. **Feldstein**. Well, I think you would have to look country by country at specific policies but I think that the general policies of the IMF have been appropriate in Latin America.

Mr. **Guarini**. What about the Export-Import Bank; do you feel that giving money to build a steel plant in Korea might have taken jobs and trade away from our United States? Is there a counterproductive policy there?

Mr. **Feldstein**. I know that that case exists. I don't know the facts in detail. I would have my doubts about the wisdom of that on the surface, but I would really have to look in more detail before I could give you a final answer.

I think that what Exim has done in other areas has been very positive. I think by forcing a negotiation on subsidized interest rates within the OECD they have avoided some of the foolish competition that otherwise existed among governments to keep interest rates artificially low in sales to foreign buyers.

I think what they have done in Mexico and Brazil is very important because clearly those countries were up against a constraint that would not have allowed them to import as much, and the Exim financing of our sales to those countries have been a very positive influence.

Mr. **Guarini**. Other than financing themselves, would you say that we should be certainly more careful in regard to financing and building various plants in foreign countries that compete with our products, especially where large wage differentials exist.

Mr. **Feldstein**. Well, I would have to know more about the specific case but I certainly think that I would want to look very carefully at it.

Mr. **Guarini**. Now, our steel industry is a problem and there is the question of a 5-year period to allow our steel plants to modernize themselves.

Given the fact that if they don't get some kind of relief they may just fade out because the competition may be too strong to maintain a profit, would you like to comment on the possibility of having a steel quota in this country?

Mr. **Feldstein**. A worldwide steel quota would be a terrible mistake. The kind of rationalization that the steel industry wants to do is a real plus. I think they can lower their costs in that way.

For us to raise the cost of steel to all steel users in this country, and that is what a worldwide quota would do, would be counterproductive.

Moreover, I think the kind of merger that the Justice Department has said it finds acceptable in the case of LTV and Republic would not be acceptable if we had a worldwide quota, if there were no way for steel from the rest of the world to compete and keep prices in line here.

So I much prefer to see a competitive solution to that problem.

Mr. **Guarini**. Well, we already have multilateral agreements on sugar and coffee.

Mr. **Feldstein**. I would rather not have those, but I certainly don't want to add more.

Moreover, if I have to ask which does more damage—a sugar agreement and a steel agreement which raise prices by the same amounts—a steel agreement, it seems to me, does more damage because it feeds through the whole cost structure of American industry and raises the cost of automobiles, raises the cost of major consumer appliances, and therefore has the effect of increasing the ease with which foreign producers can enter those markets.

The next temptation would be to see what we can do to block the imports of those products because we can say that we were unfairly disadvantaged in those industries by our own steel quota. I think that is a very bad chain to work from.

Mr. **Guarini**. Considering it as a basic industry, do you have any suggestions that you can give the committee as to what we should do with our steel plants that are out of date. What is the alternative?

Mr. **Feldstein**. A lot of the problem with the steel industry is clearly cyclical. A lot of the problem with the steel industry is the very strong dollar.

Part of it is more fundamental. Cars are lighter. One of the reasons why cars are lighter is we decided that fuel economy was very important so you all have passed laws requiring lighter weight cars. Well, when you get rid of a quarter of the steel that goes into every car, obviously there is going to be a shrinking in the size of our steel industry.

I think when the dust settles down, we are going to see a smaller but more efficient steel industry a few years from now. And if we get in the way with the Government, I don't think we are going to help that situation. I think the steel industry is going to have to continue to reconsider with its employees, with its trade unions, the level of wages.

Mr. **Guarini**. In other words, it should be able to swim by itself and if it can't, then it falls.

Mr. **Feldstein**. But it is not going to fall. It is going to be able to survive on a smaller scale.

Mr. **Guarini**. And from a national defense viewpoint, do you think it is critical to spend so much of our money? And a large part of the deficit you are talking about is military spending and steel is necessary for a strong defense.

Mr. **Feldstein**. Well, we did look at that possibility. We looked at the amount of steel capacity that would have to be maintained for military requirements and it is a very small fraction of the total steel capacity that we now have.

We are nowhere near the level of the scale for the industry that poses a national defense problem for us either currently or even in a full-scale military effort.

Mr. **Guarini**. Now, the downpayment you talk about, do you feel it is real or do you think that it is just symbolic?

Mr. **Feldstein**. Oh, no, I think it is much more than symbolic. The $150 million relative to our baseline, something that builds up to $50 billion in 1986 and $70 plus billion in 1987, that is real money.

Mr. **Guarini**. Do you accept the baseline economic assumptions in the administration's report even though they are controverted by various business schools and, CBO, and every other baseline prognosticist that we have?

Mr. **Feldstein**. I was one of those who argued against my own projections when they were made public. I said at the time that we could not have that kind of declining interest rate path. We could not have that kind of solid noninflationary growth unless we brought the deficits under control.

I made it very clear that our economic assumptions were conditional on being able to deal appropriately with the budget deficits and maintaining appropriate monetary policy.

I think if you asked them what is the underlying assumption in many of the private estimates or in the Congressional Budget Office estimates, it is that adequate progress will not be made in dealing with the deficits. They did not anticipate the kind of progress that is implied by the downpayment package this year and of a major follow-on in 1985.

But I think if you do get a downpayment passed this year, if you do come back in 1985 and follow on with much more substantial deficit reductions for 1986, 1987, and beyond, so that we can look toward a roughly balanced budget by the end of the decade, then I think that the economic assumptions—and the critical one is the interest rate assumption—actually that those economic assumptions can well be valid.

Mr. **Guarini**. I assume that what will happen in the election year is cosmetic surgery and after the election year, major surgery.

Mr. **Feldstein**. Well, $70 billion may not just be cosmetic. It may not be radical surgery. But it is serious surgery.

Mr. GUARINI. It depends on what the $70 billion is placed against.

One last question. Are you concerned that the foreign capital that is coming into the United States. Will it put our economy in hostage to the foreign nationalists?

Mr. FELDSTEIN. We are hostage to them only in the sense that there are individual foreign investors who hold our obligations, it is not like dealing with the OPEC cartel where they can gather togather in a room and hold us hostage. But if sentiment changes and the dollar falls, we then don't have the kind of capital inflow that we are looking to this year, then interest rates would be much higher here and we could not maintain the level of investment in housing and plant and equipment, even the low level of investment in housing and plant and equipment that we anticipate for this year and next year. So in that sense, I am worried.

I think it is therefore very important that we make progress on reducing the Government's borrowing, reducing the Government's Federal deficit, so that as the flow of foreign capital shrinks, we will have reduced the demand for that capital by the Federal Government and the total pool of funds available here will be larger.

Mr. GUARINI. Where is the stage when we should get very concerned about foreign capitalists' involvement in our economy? Are we a long ways from that?

Mr. FELDSTEIN. Not if you think about it as a flow. I would say that the $80 billion that we are anticipating as a capital inflow this year is of critical importance to the functioning of our economy this year. Without it, net fixed investment would be cut more than 50 percent. So that is a very serious problem.

Now, it is not going to go away this year. We know that capital is going to come and it is almost a sure thing that we will get it again next year unless there is a very sharp drop in the dollar in the next few months. And that is why I think looking ahead, 1986 and beyond, we want to make sure that the Government's borrowing is not nearly as large.

It goes back to the point you made a moment ago about what do you compare $70 billion to. I think the critical thing to compare it to is the amount of debt savings or net investment that we would otherwise have in the United States.

We are talking about net fixed investment this year of about 4 percent of GNP, about $140 or $150 billion. Therefore, the $80 billion represents half of it in terms of the capital inflow.

Well, putting $70 billion additional funds into that market and not taking them out in the form that the Government has, can take that up by a substantial amount. It can take that $150 billion up by 50 percent or can replace all of the net capital inflow that might otherwise occur in 1986. So those are very substantial numbers when viewed in relation to the appropriate savings.

Mr. GUARINI. Thank you very much for your thoughts.

Mr. FELDSTEIN. You're welcome.

Chairman GIBBONS. Mr. Jenkins.

Mr. JENKINS. Thank you, Mr. Chairman.

Mr. Feldstein, I want to thank you for the opportunity to talk to you earlier this morning. I thought it was a very helpful discussion.

As I understand your testimony, what we are really doing now is financing the fiscal deficit with foreign capital that is flowing here primarily.

Mr. **Feldstein**. Well, about 40 percent, there are different ways of saying it, but the foreign capital inflow is enough to finance about 40 percent of this year's fiscal deficit.

Mr. **Jenkins**. Is it anticipated that that foreign capital inflow will continue absent an abrupt fall in the value of the dollar? Is that correct?

Mr. **Feldstein**. It will come down gradually through time but if you look ahead next year, say we would again expect to have a large capital inflow.

Chairman **Gibbons**. Would the gentleman yield there?

There is a point that is not clear in my mind. We talked about this earlier. When you are talking about the foreign capital inflow, you are not just talking about the foreign direct investment or the foreign loans that are made in this country. You are also talking about the merchandise trade deficit as we identify it; is that correct?

Mr. **Feldstein**. When I talk about the foreign capital inflow, I am talking about the net inflow. I am talking about the difference between their flow in and our flow out.

What is that flow? Part of it is direct investment. Foreigners investing, buying businesses here, building businesses here. Part of it is the purchase of stocks and bonds by foreign pensions and banks. Part of it is deposits in American banks. Part of it is the purchase of U.S. Government securities by foreign investments. And the reverse of it is a reduction in the scale of our outflow of capital abroad, the reduction in our bank lending to foreign firms, the reduction in overseas investment by American businesses and American banks.

So what we are seeing is a shift in where this capital goes.

Now, the relation between the trade deficit and this capital is that to the extent that we run a trade deficit, say $110 billion this year, we have to pay for that. We have to pay for and can pay for it in part by the interest and dividends that we earn on our foreign investments and in part by sale of services, shipping, insurance, banking services to the rest of the world.

But when all that is done, we are still going to have a shortfall of about $80 billion. We would expect that that $80 billion would be financed by the difference between the capital inflow into the United States and the rest of the world and the outflow from this country of financial capital to the rest of the world.

Mr. **Jenkins**. When you are speaking of a net figure, part of that is reflected, is it not, simply because U.S banks are now more reluctant to make loans to Argentina, Brazil, and Mexico. Therefore, a lot of that money is staying here reflecting an increase in the net figure.

Mr. **Feldstein**. That is correct.

Mr. **Jenkins**. The emphasis might not necessarily be on the fact that foreigners are trying to invest here. We are investing smaller amounts over there.

Mr. **Feldstein**. That is absolutely right, yes. And some of that is because of an increased perception of risk in foreign investment and part of it is because instead of money going into securities in Europe and banks in Europe and American investors are saying the yields here are just so much better, why don't we keep our money here and not send it abroad?

Mr. **Jenkins**. It is like having colonization. Instead of our colonizing, other people are colonizing us. Isn't that what we are coming down to now?

Mr. **Feldstein**. Well, I wouldn't call it colonization.

Mr. **Jenkins**. So it may be in our best interest at this particular time that U.S. banks are not making many loans to many foreign investors.

Mr. **Feldstein**. As I was saying at breakfast, there are many pluses and minuses to whether we have a trade deficit and a domestic deficit at the same time. The trade deficit clearly hurts importers from abroad. At the same time, it means that we are getting this substantial increase in funds available in this country for domestic investment.

If we had a trade balance, then we would not have as much of a capital inflow from abroad or we would have more of a capital outflow from the United States; and if that were true, then the level of housing investment and the level of plant and equipment investment would be lower.

Mr. **Jenkins**. So your feeling is that to some degree the trade deficit is perhaps equalizing or helping in a temporary situation with the budget difficulties?

Mr. **Feldstein**. That is exactly right. The budget deficit requires a cutback of other activities in this country. And to the extent that we bring in these funds from abroad, we don't have to cut back on our investment as much in this country at this time.

Mr. **Jenkins**. Do you know, if this increase in foreign capital is attributed to a real increase in foreign capital into this country? How much is reflected by the banks not investing in foreign countries?

Mr. **Feldstein**. I don't have a number for that. One problem with interpreting any number is if a Dutch pension fund decides to invest in Canada directly, then it doesn't affect us at all.

If, on the other hand, it decides to put its money in a New York bank and that New York bank invests in Canada, it is really the same net effect, and yet it shows up very differently on our books. It shows up as an inflow from abroad and an outflow from the United States. So it is not very meaningful to take these gross flows in and gross flows out and try to analyze them separately, at least without going into much more detail about the individual countries involved than I have been able to.

Mr. **Jenkins**. If the Congress and the administration should fail this year to pass the downpayment or a little bit of the downpayment on the deficit, would you anticipate that interest rates would rise?

Mr. **Feldstein**. I think they would.

Mr. **Jenkins**. In the event that we pass either of the various plans calling for some revenue increase, all of them in the ballpark of $100 to $200 billion for 3-year plans, would you anticipate that that would bring down interest rates at all?

Mr. **Feldstein**. Well, I think it should bring down rates, especially longer rates at least relative to what they would otherwise be. I think the strength of the economy may continue to put upward pressure at the short end of the market and after all, what we are talking about in all these deficit reduction plans is changes in Government borrowing, not in 1984, but primarily in 1986 and 1987 and beyond, so that the long-term real interest rates ought to be coming down as a result of this. The market interest rates, both long and short, also reflect inflation expectations.

I would hope that a reduction in future deficits would give greater confidence that we will continue to keep inflation under control. But anything that causes the financial markets to worry more about inflation tends to put a premium on especially long-term interest rates.

Mr. **Jenkins**. Would the deficit and inappropriate monetary action be part of this?

Mr. **Feldstein**. Correct. And I think if that is done, we ought to see long rates either falling or at least not rising, and if we don't have that combination, then I think long rates would be on their way up.

Mr. **Jenkins**. Thank you, Mr. Chairman.

Chairman **Gibbons**. Thank you, Mr. Jenkins.

Mr. Schulze.

Mr. **Schulze**. Thank you, Mr. Chairman, and thank you, Marty. When you discussed with Mr. Jenkins the scenario of money being deposited in a New York bank and then loaned to the Canadian bank, it triggered a thought in my mind. I have a personal theory that because of increased communication, especially satellite communications and electronic transfers between financial institutions, that we have a shrinking financial institution situation here in the United States that by the turn of the century, we will have dramatically fewer in number of financial institutions.

This will lead to larger world-wide banking networks or even, if it is correspondent associations rather than several large worldwide banks, but anyhow I think the satellite communication is going to tie this all together; and as a consequence, I think some of that is happening now, these figures mean less than they did previously and will probably mean less as time goes on.

I guess what I am saying is that they can be very misleading because of the scenario you described and that that, in my opinion, can be exacerbated in the future, and I just wondered what your opinion of that is?

Mr. **Feldstein**. I don't understand why you think they are or would be misleading?

Mr. **Schulze**. Well, because when you can instantly transfer funds from Italy to New York and then to Zurich within a matter of a few minutes, those transfers show up as figures on a report, but really went from Rome to Zurich and the fact that it came through New York doesn't mean an awful lot; and as a consequence, some one looking at those figures could be misled.

Mr. **Feldstein**. Yes, I think it is very important to look at the net number for that reason. That is why these gross inflows and gross outflows I don't find are a particularly helpful way of looking at the problem. I think there has been some discussion, particularly in some of the press, about looking at the gross inflow numbers and gross outflow numbers, but I don't know how to interpret them for just the reason that you say.

Mr. SCHULZE. One other question.

Just as industries are cyclical, a cursory examination of currency valuations says to me that there are cycles. I haven't studied this in depth and so I am asking for your expertise. A cursory examination also shows, or would lead me to believe that we are going to continue perhaps a little bit of devaluation on the dollar, and this will have a somewhat correcting influence on the trade deficit within the next 18 months to 2 years. And I just wondered whether you agree with that.

Mr. FELDSTEIN. The most likely thing to happen is a continued gradual decline in the dollar in the foreseeable future, but with a lot of little oscillations as investors respond to changing expectations about what we are going to do on the budget deficit or what is going to happen in financial markets. But basically the dollar has to come down over the next several years until we get our current account more nearly in balance.

Mr. SCHULZE. Historically, are there clear cycles because of psychological swings or is it a reaction of the market, period?

Mr. FELDSTEIN. It is really not a cyclical process in the sense of the business cycle, but it is subject to other influences. The budget deficit that we have been talking about now, the structural budget deficit, is a prime mover in this. Periods of inflation, quite apart from business cycle conditions, will shift the exchange rate.

Mr. SCHULZE. So the international money gnomes are not influenced by emotion? They try to analyze in a cold, cruel, heartless way?

Mr. FELDSTEIN. Yes, but often that is an emotional response. It is a sense of where they think the other gnomes are going in the weeks and months ahead in a desire to get there first.

Mr. SCHULZE. Thank you, Mr. Chairman.

Chairman GIBBONS. Mr. Feldstein, I don't want to get you into an argument with Mr. Volcker, and I don't want to get you in an argument either with any news reporters, but in the Washington Post last February 29, there was a headline on page C-3 that says "Volcker sees investment from overseas as threat." And then there was an article by Jane C. Berry, and she starts off in her lead paragraph saying "Federal Reserve Chairman Paul A. Volcker said yesterday the U.S. economy is being held hostage by foreign investors helping to finance American borrowing needs, and the situation could soon reach crisis proportions."

Now I realize it is unfair to have you comment on what Mr. Volcker said, and I realize it is unfair because Mr. Volcker is going to be along here a little later on, but generally, you apparently don't agree that we are in any threatening circumstance due to foreign investment?

Mr. FELDSTEIN. The sense in which it is a threat is that if individual foreign investors came to feel that they didn't want to hold more dollar securities or American source securities and the dollar fell substantially, then a year or so from now we would not have an $80 billion capital inflow. The exporters would be happier and the folks who have to compete with imports from abroad would be happier, but suddenly we would discover that our domestically available capital supply was much, much lower.

If that happened before we had done something about deficits in the Federal budget, the result would be very high real interest rates in the United States and a sharp cutback in the growth of the capital stock including housing and plant and equipment.

In that sense, I agree with Chairman Volcker. I wouldn't say that the problem was imminent, that it was going to affect the American economy in 1984. I think that it is not likely to be the outcome in 1985, but it is a risk. That is why it is so important that the Congress moves ahead to make progress on reducing the future Federal borrowing.

Chairman GIBBONS. Let's go back now to the beginning and turn your attention to those charts over here. We got these figures from the U.S. Department of Commerce, and they are to some extent not properly labeled because they should read U.S. trade balance in the merchandise account.

Mr. FELDSTEIN. Yes.

Chairman GIBBONS. If we wanted to affect those in a positive way, what should we be doing to make them come closer to the zero line or maybe even in the surplus? What should we be doing and in what timeframe should we be doing it?

Mr. FELDSTEIN. I begin to sound like a broken record, Mr. Chairman.

Chairman GIBBONS. That is why I want to get it drilled in. I notice that Art Pine came in late, and I want to make the point. I want to give him a break.

Mr. FELDSTEIN. I think he knows what I say on my record, but we don't want to slow down our recovery. If we went back into recession, that would help to turn that around. The main thing that we want to do is to make the dollar more competitive, bring down the real value of the dollar.

How can you do that? You can do that by an increase in inflation or inflation expectations here, but we certainly don't want to do that. We can do that by frightening foreign investors that we might lock their funds away and not let them repatriate them. We don't want to do that.

So the only thing that we can do is reduce the pressures that are keeping real interest rates so high here, the large budget deficit, and I think we want to do that, and indeed if we could shrink the trade balance without reducing the budget deficit, that would be a very mixed blessing because, as we have been saying before Mr. Pine came, the consequences of doing that would be higher real interest rates and less investment in housing and plant and equipment in this country.

Chairman GIBBONS. Thank you.

Are there further questions?

Mr. GUARINI. I just want to say, aren't there suggestions that could be made such as more research and development, more activity, better retraining of our people, more engineers being put on the line in the population? Aren't there a lot of fundamental things that should be done rather than just looking at numbers all the time?

Mr. **Feldstein**. Those things would help the industries that benefited from it. If we improve productivity in the steel industry, we would have fewer imports of steel. If we improved productivity in agriculture, we would presumably have more exports of agriculture. But the whole trade balance would not necessarily change at all in that process.

Taking agriculture. If we could find a way through all the research and development to double the output of our farms or indeed to increase output just by pulling back on some of our programs which restrict farm output, we increase the output of farms and exports, which that would have the effect of weakening our exports of manufacturing goods. It would push up the value of the dollar.

Mr. **Guarini**. And we could have a PIK program for computers.

Mr. **Feldstein**. And that is not really what we are trying to do. We are not just trying to move around the trade deficit between one place and another. I am not saying there is anything wrong with increasing productivity. Far from it. We obviously want to do that. It is a good thing in itself.

There is nothing wrong with pressing on other countries to give our products a fair chance of being sold there. They increase the real return to American workers and American capital, but they will not necessarily change our short-term trade balance.

Mr. **Guarini**. Let me ask one last thing. We have the dollar as the world standard and, of course, that might tend to artificially keep it at a premium because it is the world standard, is that a fair statement? And if that is so, doesn't that really work against us?

Mr. **Feldstein**. You look back to the late 1970's when the dollar was a third lower than it is now, that was certainly possible even though the dollar was still essentially at that time the same standard that it is today. At that time, because the dollar was falling because of domestic inflation conditions here in negative real short-term interest rates and the like, the mark was becoming more important.

Mr. **Guarini**. But we get bigger swings this way, though.

Mr. **Feldstein**. No, I wouldn't say we get bigger swings because of our reserve currency status. I would say that the basic reason for the swing at its start was that we convinced the world we were off our inflation kick, that we were capable of bringing our inflation down, and, therefore, this was a safer currency to invest in. And then before that effect had time to reverse itself at all, we have had these large budget deficits and very high real interest rates.

We have got a combination of high real return and a sense of safety that we are not going to return to inflation with all the adverse effects that that would have on the value of American securities and of the dollar.

Mr. **Guarini**. So you would make no suggestions in changing the dollar as the world standard or go into any other kind of commodity, gold, currencies?

Mr. **Feldstein**. We benefit to the extent that other countries' central banks are prepared to hold Treasury bills. We are, in effect, getting a cheap line of credit from others freeing up capital here to invest in real equipment which has a much higher yield than the

Treasury bills which foreigners are holding. So I wouldn't want to change that.

Mr. **Guarini**. So the whole esssence of your testimony is to reduce the deficit. That is what it really basically comes down to.

Mr. **Feldstein**. It is what the title VII says.

Mr. **Guarini**. Thank you.

Chairman **Gibbons**. Mr. Frenzel.

Mr. **Frenzel**. Chairman Feldstein, I apologize for not hearing your full testimony and discussion here. I would like to ask a question. I approve of the title of your treatise. However, let me try to bring the issue down to a little more immediate terms.

If I were the CEO of one of our distressed industry companies, say I am chairman of a steel company and I come to you. You are not the CEA, you are good old Marty, local consultant. And I say my industry and I have decided that the best thing for us to do is to promote as quickly as possible this quota bill that we are promoting, and I am for that.

What do you think is the best thing that I and my brethren in my industry or other types of distressed industries might do over the next couple of years, either in addition or differently, that will take care of our interests. Never mind the national interests. What is going to take care of me and my steel company?

Mr. **Feldstein**. Well, one thing I might say to you in my role as your local private consultant is that you have to ask yourself whether, viewed purely from the point of view of the steel industry, that kind of worldwide quota is going to be a big help because it is not free. You are going to have to give something up as an industry in the process.

The Justice Department, for starters, is going to take a very different view about other things that you as an industry want to do. You come along and say "Allow us to merge two major steel firms," rationalize and improve efficiency in the process. And "Don't worry," you will say to the Justice Department, "about the consequences of that for concentration because after all, it is a worldwide market."

And the Justice Department will reply, "We are very sorry, Mr. CEO, not anymore." It used to be because we could import from Korea or from Canada or from other countries, but now you have put a 15-percent quota on; there is no price competition from the rest of the world, just a token amount that comes in independent of the price that you charge.

You now, as an industry, have much more potential monopoly power, and we in the Justice Department, therefore, have to take a much tougher stand on these mergers. So you have to ask yourself then and your brethren in the steel industry whether it is really to your advantage to put a quota on if the price that you are going to pay for that is that you will not be allowed the rationalization that you need to get cost savings.

Mr. **Frenzel**. So in other words, you have got to be able to save enough money the next 5 years to get competitive by yourself?

Mr. **Feldstein**. You are now the consultant and I am the CEO?

Mr. **Frenzel**. That is right.

Mr. **Feldstein**. Or you have got to convince private industry that you do have the capability of doing it, private financing, that you do have the capability of doing it or you have got to do some merging with nonsteel companies to get the financing from that source.

The other thing, of course, is what happens to your wage costs if I assure your work force that they are now protected from foreign competition. In effect, we were protected in our steel industry and auto industry and some others from foreign competition in the past, not by quotas, but by the fact that other countries didn't have the technology and that shipping costs used to be a much more important consideration than they are now.

And I think that was why with the steel industry, in effect, having a monopoly over the American market over those years and the auto industry, why wages were able to get far out of line with wages elsewhere in the American economy.

If you go back to that kind of a noncompetitive situation with a 15-percent worldwide quota, you may find, particularly in the steel industry even more so than in the auto industry, that pressure in the collective-bargaining process will eat up whatever profits you might otherwise have gotten.

Mr. FRENZEL. Thank you, Mr. Chairman.

Chairman GIBBONS. Before we get out of that line of questioning, I suggest that perhaps there is another question that you as a private consultant would want to be talking to the CEO about. You would want to ask him what impact is this going to have on his customer and his customer's customer? Is that a legitimate observation?

Mr. FELDSTEIN. Yes, absolutely. I think I said before, although I didn't in my new role that Mr. Frenzel assigned me, I didn't remind myself and him of it, that if we start by raising the price of steel, then what do we do to auto prices and what do we do to other importable goods? Suddenly we may discover that the auto industry is no longer as competitive in world markets or the heavy consumer appliance industry is no longer as heavy and as competitive in the world markets because we have raised their prices.

Chairman GIBBONS. Therefore, when you recover, you won't have a customer to sell to anyway.

Mr. Jenkins.

Mr. JENKINS. I have a followup question to Mr. Frenzel's hypothesis. As I understand it in the question, this steel person or textile industry is simply trying to survive for another year or another 2 years.

I understand the long-range implications. Is he simply trying to hold on for 12 months or 24 months? What do you tell him then about his support of quotas?

Mr. FELDSTEIN. Well, my impression is they are holding on. They are surviving. They are asking themselves how to cut costs. They are looking for ways of merging. They were successful in getting some wage rollbacks to make themselves more competitive and all that is healthy.

Mr. JENKINS. Well, I don't know that much about the steel industry, but let me talk a minute about the textile industry that has had some quotas, and I would be the first to admit that they are not working. But this has not driven up the wage rates in the textile industry. It is a very low wage rate industry.

The textile apparel trade deficit hit a record level in 1983, $10.6 billion, 15 percent of the Nation's total trade deficit in apparel and textile. For the first month of this year, 1984, textile trade deficits was $1.17 billion, a 24-percent increase over the previous year. If you annualize this, it amounts to $14 billion or 33 percent higher than 1983.

In a small textile manufacturer or apparel plant in Georgia, South Carolina, or wherever, he doesn't know whether he can survive another 12 months. Now over the long range, maybe he ought to move into some other endeavor, but he is trying to hold on for 12 months. Do you blame him that he doesn't want to merge?

Mr. **Feldstein**. I do blame him very much because when I look at the capacity utilization figures in that industry, I see they are about as high as any industry in the country. They are running over 90 percent. So I don't understand why he is having a hard time holding on and making it through the year if he is operating at more than 90 percent of capacity.

Mr. **Jenkins**. Well, why are the apparel places closing?

Mr. **Feldstein**. What I said is a fact. If you look at the current capacity utilization, they are right up there at the top.

Mr. **Jenkins**. What it amounts to is that they simply can't compete.

Mr. **Feldstein**. They are using every bit of capacity they have to sell in this country. I believe that a certain part of that market can't compete. The labor intensive apparel market cannot and should not compete with the much lower cost labor elsewhere. The stuff depends on somebody sitting at a sewing machine and stitching sleeves on, it is crazy to hurt American consumers by forcing them to buy that at $4 or $5 an hour of labor. We ought to be out of that business.

But right now what we have is an industry that is operating at capacity in textiles.

Mr. **Jenkins**. What if the same thing is true in steel? Korea, or whoever, can simply get labor a lot cheaper than we can.

Mr. **Feldstein**. The steel industry people that I have talked to say that we are, in the long run, competitive in that industry. It does require rationalization and that they can do it and they don't walk away from it. They say that labor costs are a problem, but not unsufferable. The high cost of capital in this country is a problem, and the strong dollar is a problem.

But if we think that in fact over the next few years we are going to bring down interest rates as the Government borrowing shrinks, we are going to bring down the dollar, then we are increasing substantially the competitive position of those firms, and they see their ability to stay in there; occasionally by merging, in part by closing down some of their least efficient facilities.

I think they have problems under the current tax law, but you know more about that probably than we need to talk about today.

Mr. **Jenkins**. The steel industry has real difficulties without any question.

Mr. **Feldstein**. They do, particularly in getting the capital to modernize.

Mr. **Jenkins**. I think the fear of a lot of people is simply this. You know the Forest Service has in cutting timber, they do a lot of clearcutting. I prefer selectively cutting the timber. I think the steel industry is a little bit fearful that we are about to clearcut the steel industry and a lot of other domestic industries.

In the long term, you know the timber will come back, maybe in a different species and so forth and maybe different types of industries. Maybe we don't need the apparel industry and we will get into something else, but short term causes real problems that bring about the emphasis on quotas to survive just a few months longer. Obviously, it is self interest, but it is self interest of Americans that are working.

Mr. **Feldstein**. When I talked to my counterparts in Europe, and I listen to them worry out loud about the same kinds of problems which, in many cases they faced earlier, loss of competitiveness of steel or shipbuilding or other major industries. I think they think they made a mistake by doing too much protecting. It is very hard to protect for a year or 2 years and as a result, they are pouring vast amounts of money into keeping alive firms and industries that are just a drain on the public sector, a drain of the taxpayers and not really capable of long-run survival.

The financial market is a much better judge of what is capable of long-run survival than the political process.

Mr. **Jenkins**. Thank you.

I just feel, though, that there ought to be a better alternative to surviving than wanting to merge or needing to merge with other companies whether it be in the same field or not.

Thank you, Mr. Chairman.

Chairman **Gibbons**. Mr. Pease.

Mr. **Pease**. Thank you very much, Mr. Chairman.

Mr. Feldstein, I would like to talk with you about a subject on which you are an expert—Federal deficits—and to begin by commending you for your consistency in the face of adversity in trying to call public attention to the problems that deficits create.

I think it is understood that high budget deficits run the risk of reigniting inflation, and consequently high interest rates discourage capital investment. What is the likelihood that deficits will trigger another recession?

Mr. **Feldstein**. As I have said a number of times in the past, large budget deficits raise the risks, but certainly don't have any inevitability about producing another recession. You raise the risk by making the recovery more lopsided than it otherwise would be and also, as we see and as we discussed at the breakfast this morning, we have got the problem of moving from $200 million deficits back down to zero.

That, in itself, is a contractionary process. That contraction is going to be offset, we hope, by more investment, more housing, more net exports, but getting those two to mesh in time is important if we are to avoid creating a recession in the process of coming out of these deficits.

So it is a delicate problem, but I don't think there is anything inevitable about deficits. I think if we get this downpayment package enacted now, that is a real plus. If we make it clear also that that is a downpayment and that Congress expects to come back in 1985 and do substantially more, then I think we can see the kind of fall in interest rates and a more competitive dollar that will provide strength in those industries at the same time that the shrinking budget deficit contracts demand in other parts of the economy.

Mr. **Pease**. Within reason, deficits fuel economic growth. I guess I am trying to trace whether there is any direct cause and effect relationship. What if the budget deficits are not addressed by the President and by Congress and we were to continue to have $200 billion deficits over the next several years? Can you find any direct relationship between that kind of sustained deficit pattern and the likelihood of more recession?

Mr. **Feldstein**. Let me point to two ways in which it could happen without making either of them a prediction, but just talk about ways it could happen. We continue to have large budget deficits next year. As we get closer and closer to full employment in some sectors of the economy, but not in others, we might see inflationary pressures building up there.

Well, then, what does the Fed do? It continues a sound anti-inflationary policy. It prevents those inflationary pressures from being realized but only at the expense of slowing down the overall real rate of growth.

In other words, the budget deficit and the lopsided character of the recovery puts different pressures and presents a different tradeoff between inflation and real growth in the near term than might otherwise occur.

Mr. **Pease**. Now that is an economic trail of events.

Is there, in your opinion, any psychological factor at work that could trigger or accelerate a recession?

Mr. **Feldstein**. Yes; although I suppose economists like to use the word "expectation" rather than "psychology." It comes down to the same thing. It is the expectation of future deficits going on year after year into the future that keeps real interest rates high now.

As you said, the current deficit is, in itself, stimulative although it can cease to be as we get closer to full employment, although the current deficit is stimulative, the prospect of future deficits by keeping interest rates very high now can so depress interest sensitive activities, investments and net exports that it can have just the opposite effect.

Mr. **Pease**. Assuming for the moment only a moderate effort by Congress this year to reduce deficits—let's say Congress approves $150 billion or less over 3 years as a downpayment on a projected $700 billion deficit over 3 years. Where would you put the likelihood of a recession occurring in 1985?

Mr. **Feldstein**. It is just too hard to put a number on that, but I would say if we have a downpayment package of the magnitude that the administration proposed, I would say that the risk that the deficit itself will be the source of a downturn or a recession in 1985 would be very, very low, that other things could occur that caused it, but the tensions created by the deficit I think would be very much reduced by that kind of legislation at this point.

Mr. **Pease**. One reason that I am such a supporter of yours and hope that Congress will be active this year in deficit reduction is that I think the clock is ticking away and that we may run out of time. My worst fear is that something will trigger another recession in 1985, at which time the $200 to $250 billion deficit will only go up as unemployment compensation costs and welfare costs go up and ordinary Federal revenues diminish.

Would you agree that if a recession were to occur, say, sometime in 1985, it would be nearly impossible and probably even inadvisable for Congress to raise taxes at that point as a way of reducing deficits? Wouldn't you just let the deficits grow?

Mr. FELDSTEIN. If we found ourselves in 1985 in a recession, and I do not think that is likely, but if we did, then I think the appropriate thing would be legislation that started to shrink deficits out in fiscal 1987 on the assumption that by then we would be back in recovery. But, of course, that means postponing the whole process, building up a larger amount of national debt, having less capital accumulation and more foreign debt during that same period.

So it is clear that we want to get that process started sooner if we can.

Mr. PEASE. Thank you very much.

Mr. FELDSTEIN. You are welcome.

Chairman GIBBONS. Mr. Feldstein, I want to personally thank you. You have been with us since quarter of 8 this morning, and I don't know of anybody that ever got as much out of a dollar and a quarter breakfast as we did this morning. You have been here almost 2 hours now, and we appreciate it very much. You have been very helpful, and thank you so much.

Mr. FELDSTEIN. I enjoyed being with all of you. Thank you.

Chairman GIBBONS. Our next witness is the Honorable Beryl W. Sprinkel, the Under Secretary of Treasury for Monetary Affairs, and also no stranger to this committee. And, Mr. Sprinkel, we didn't get a chance to eat breakfast with you this morning. It wasn't a very good breakfast, but the conversation was stimulating, and I don't believe Mr. Feldstein has ever been called upon to do so much work for so little pay unless he had to pay for his own breakfast in the past.

We appreciate your coming, and you may proceed as you wish and go right ahead.

STATEMENT OF HON. BERYL W. SPRINKEL, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS

Mr. SPRINKEL. Thank you, Chairman Gibbons, and other distinguished Congressmen. It is indeed a pleasure to appear before this subcommittee to discuss the U.S. trade deficit.

I will submit a longer bit of testimony for the record and give you a brief synopsis, if I may.

Chairman GIBBONS. Without objection, we will include the whole statement. Go into your synopsis, and then we will go to the questions and answers.

Mr. SPRINKEL. Thank you, sir.

Measured in the way that it appears in our overall balance of payments, the trade deficit grew to $61 billion last year and most forecasters anticipate that it will reach at least $100 billion this year.

Taking into account U.S. trade in both goods and services, as well as transfer payments and receipts, the U.S. current account swung from a surplus of $4.5 billion in 1981 to a $41 billion deficit last year. Now, in addition to the $32.5 billion widening of our trade deficit over this period, there was a $12.5 billion decline in our surplus on net invisible transactions, mainly investment income.

While we expect some recovery in investment income, next year's current account deficit will likely be in the $70 to $80 billion range. Such large figures lend themselves to dramatic rhetoric and calls for urgent action.

In my remarks today, I will address a number of important issues which need to be borne in mind by the Congress and by the administration in reacting to these requests. These issues include the causes of the widening of our trade deficit, the impacts of the deficit on both the American economy and the rest of the world, and our views on the appropriate policy response.

There have been three major factors in the widening of our trade deficit. These are the strength and timing of the U.S. economic recovery, declines in our exports to developing countries which are experiencing financial problems, and the appreciation of the dollar on exchange markets over the past 3 years.

Our strong recovery has led to rapid increases in U.S. imports while growth in our major export markets fails to keep pace. As a result, our trade balance with industrialized countries worsened by some $25 billion between 1981 and 1983. Given the hue and cry over Japan, one might expect our trade with Japan to have been a major part of this. But, in fact, our deficit with Japan only widened by $4 million, chiefly due to higher U.S. imports. A ballpark estimate for the direct effect of high U.S. and weak foreign growth on our trade balance is about $15 to $20 billion this year.

Our trade performance with developing countries has been strongly influenced by their debt problems over the past 2 years. Our largest single trade balance deterioration has been with Mexico. U.S. exports to Mexico dropped by half, from $18 billion to $9 billion between 1981 and 1983, and our balance with Mexico worsened by $12 billion.

There was a deterioration of nearly the same size with other non-OPEC developing countries and smaller trade losses with financially troubled countries in Eastern Europe. In addition, while there is no way to quantify it, LDC debt problems have undoubtedly had an indirect negative effect on our exports to other industrial countries by lowering their own exports and real growth. A ballpark estimate of the debt-related part of the widening of our trade deficit would be at least $25 of the $30 billion.

Finally, a significant portion of the U.S. trade deficit was attributable to the appreciation of the dollar on foreign exchange markets. Between the beginning of 1981 and this January, the dollar appreciated roughly 30 percent on a weighted average basis against the other major currencies. Although it has since depreciated somewhat, it takes roughly 2 years for the full impact of an exchange rate change to be evident in our trade balance. As a result, the exchange rates driving this year's trade deficit will still be mainly those of 1981 and 1983 when the dollar was appreciating.

While there is general agreement on the direction of the impacts of exchange rate changes on trade flows, it is much more difficult to pinpoint the side of those impacts. There are a number of analytical techniques which can be applied to this issue, but unfortunately they lead widely differing estimates; therefore, I have little confidence in them.

Estimates which attribute to the dollar, the part of the deficit increase which is not explained by relative growth rates or debt problems, run as low as $25 billion for this year. But at the high end of the range are estimates from simple econometric models which reach as high as $100 billion. There are substantial technical problems with all methods of performing this calculation; and econometric models in particular have poor track records in predicting the impacts of large shifts in economic variables.

The most we can say with any confidence is the truth probably lies between $25 and $100 billion, and that doesn't give me much confidence. That is a very wide range.

There are many who would argue that regardless of how large or small the impact of dollar appreciation actually is, it has been artificial and unhealthy. Thus, we are told that the dollar has been driven up unnecessarily by an excessive budget deficit and high interest rates.

In response, I would point out that whatever connection one believes there may be between budget deficits and interest rates, in practice there has been very little correlation between interest rates and exchange rates. I realize that is contrary to conventional wisdom, but I believe it is a true statement.

Over the past 3 years, the dollar appreciated substantially against all major currencies; yet interest rate differences moved against the dollar, not in favor of the dollar. There is a similar pattern in the recent depreciation of the dollar. The dollar has appreciated since January 10 against all major currencies while interest rate differentials have moved in favor of the United States. That is, unfortunately our interest rates have gone up somewhat relative to interest rates abroad.

It is notoriously difficult to measure real interest rates since inflation expectations play a central role.

Work at Treasury suggests that real interest rate changes and changes in the dollar are also not closely correlated. Alternative techniques to deal with the problem of measuring real interest rates in other countries can yield a wide variety of different estimates primarily because the lags can vary depending on what you believe affects expectations.

More fundamentally, both the appreciation of the dollar over the past 3 years and its recent depreciation reflect the normal working of the international adjustment process. The concept that the dollar has become overvalued is intuitively appealing, but in my opinion, a misleading guide to economic policy.

Most estimates of the degree of dollar overvaluation are based on the assumption that the exchange rates between two countries should move only to offset differing national inflation rates so as to keep the international price competitiveness of traded goods unchanged. Now, decades of economic research have failed to verify this purchasing power parity theory of exchange rate determination in the short run, and there are even problems with it over the longer run. This should not be too surprising since it was designed to explain only one dimension of the behavior of merchandise trade which, in turn, is only a small part of total international transactions.

The major reasons for the appreciation of the dollar over the past 3 years have been: one, fundamentally better U.S. economic performance and prospects on inflation, growth and business profitability; two, weaker performance and prospects in other major industrial countries; and third, safe haven capital flows prompted by economic and political turmoil in the Middle East, Latin America, and Eastern Europe.

Because the strength of the dollar has mainly been a result of our economic successes, there was nothing we could or should have done to keep the dollar from appreciating short of weakening our own economy to match the rest of the world. That is not a very attractive alternative, at least to me and I am sure you as well.

Similarly, we see no reason to be concerned about the recent orderly depreciation of the dollar. Several of the factors which have been pushing the dollar up are now shifting.

International investors may be recognizing that the most rapid and dramatic improvements in the U.S. economy have already happened and that many other industrial countries are beginning to catch up. Similarly, the historic turnaround in U.S. inflation performance has largely run its course for now and we are entering, unfortunately, a temporary period of slightly higher inflationary rates.

In addition, as some troubled debtor countries come to grips with their problem, capital flight is a little reduced and we hope it remains that way. Finally, at some point currency depreciation in response to a widening current account deficit is a normal part of the international adjustment process and it is working. Over time, dollar depreciation should help to moderate both the U.S. trade and current account deficits and foreign surpluses.

What about the impacts on the United States and global economy? Despite occasional assertions to the contrary, a widening U.S. trade deficit has not been an unmitigated disaster for either the United States or for the rest of the world. For each there are both gains and there are also losses. Trade developments cannot be judged in isolation from other economic developments and policies.

One direct impact of the deficit, and this is the bad part, will be to make output and employment in U.S. internationally traded goods industries lower than it otherwise would have been. We recognize that and we are concerned.

However, it should be remembered that the widening trade deficit is, to a large extent, an indirect result of our success in cutting inflation and revitalizing the American economy. The benefits of our policies and our noninflationary recovery have helped to offset negative impacts of a bigger trade deficit not only for the economy as a whole but also for traded goods industries. Profit reports, stock market results and productivity and employment gains in U.S. manufacturing industry do not seem to indicate a deindustrialization of America.

In addition, for American consumers as a group, there are significant gains from a lower cost of imported goods which leads directly to lower inflation and increased real buying power. Greater competition impacts indirectly on our inflation rate as well by keeping the pressure on U.S. firms for lower costs, greater efficiency, and lower prices.

Some analysts have complained that the strong dollar and the widening trade deficit are causing the current U.S. recovery to be unbalanced and therefore unsustainable. Not only was our 6.2 percent real GNP growth rate during 1983 about in line with growth at the same stage of previous recoveries, but the pattern of that growth was healthy.

Consumer spending, particularly durable purchases, housing, business investment, and even exports have all made greater contribution to this recovery than in previous ones. Weaker than average contributions came from Federal spending, and that is not an unmitigated evil, State and local government spending and from net exports.

What is particularly striking is that interest sensitive categories all made greater than average contributions to the recovery so far and that business investment, which is so crucial to sustained growth, is booming most of all.

For the rest of the world, the impacts of our trade deficit are in many ways a mirror image of impacts on the United States. Trade gains have been a significant factor in helping to solidify the hesitant economic recovery in Europe.

In the longer term, improved trade balances in less developed countries are necessary to enable them to service their debt in an orderly manner. For these improvements to take place, there must inevitably be a counterpart swing toward deficit among their trading partners. Our widening deficit is thus clearly facilitating the economic adjustments which financially troubled developing countries must make to resolve their international debt problems.

As is probably clear by now, we do not believe that the widening trade deficit should precipitate major changes in U.S. economic policy. Many possible U.S. policy changes would be counterproductive.

In addition, we believe that forces are already in motion both through Government policy actions to strengthen economic performance and manage debt problems and through the working of the international adjustment process, to address the major causes of our widening trade deficit.

One set of policy responses which we have consistently rejected is direct action to drive down the dollar's exchange market value. Intervention is not capable of doing so and imposing capital controls would be a self-destructive act.

There have been proposals over the past year to correct the U.S. trade deficit and to modify the impact of foreign competition on U.S. industries by restricting foreign access to the U.S. market and by subsidizing U.S. exports. Protectionism can have serious negative impacts on the U.S. economy through a general increase in inflation, higher prices to industries dependent on the protected imports and the risk that the countries affected by the import restraints will retaliate.

General measures to restrict imports are clearly not in the U.S. national interest. Imposition of an import surcharge or quotas under section 122 authority would similarly increase inflation, be likely to lead to retaliation by our allies and cut the ground from under U.S. efforts to restrain protectionism in other countries. Such an outcome could deal a serious blow to the noninflationary world recovery that is now developing.

A general surcharge, furthermore, might well be offset—and probably would be—by a corresponding appreciation of a dollar, leaving our competitive position largely unchanged. Alternatively, under some circumstances it could be viewed as a reckless panic reaction which would weaken confidence in the U.S. economy and U.S. leadership. Either way a surcharge or quotas under section 122 would, in my opinion, make no sense.

Nevertheless, U.S. industries do have a legitimate right to seek redress from unfair foreign practices such as the use of export subsidies in dumping and to seek relief from surging imports. This administration will continue to actively enforce our trade laws.

On the export side, the administration has been concerned about the impact of foreign export subsidies, especially in the agricultural area, on our ability to compete in third markets. We have directly subsidized exports to individual markets such as Egypt to bring this point home and are working both bilaterally with the European Community and multilaterally within the GATT to reduce export subsidies for agricultural products.

We are prepared to continue these selected subsidies as necessary. However, we do not see a need for broad export subsidies for all U.S. exports to offset the impact of the strong dollar. Such subsidies would be extremely costly to the Treasury at a time when we need to sharply reduce Government expenditures. They could spur foreign imposition of countervailing duties and these too could set off an escalation of disruptive trade competition that will benefit no one.

In conclusion, I would argue that we are already doing everything which can profitably be done to deal with the trade situation. We are encouraging other countries, developed and developing, to get their own economic houses in order. We are continuing our efforts to strengthen U.S. economic policies and performance including a determined effort to reduce future budget deficits.

Thank you, sir.

Chairman GIBBONS. Thank you, sir, for a very interesting and learned statement.

[The prepared statement follows:]

STATEMENT OF HON. BERYL W. SPRINKEL, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS

Mr. Chairman, Congressmen, it is a pleasure for me to appear before this Committee to discuss the U.S. trade deficit. The trade deficit is a complex and increasingly controversial topic. Complex, because it responds to changes in U.S. and foreign economic conditions as well as to U.S. and foreign trade policies, the availability of trade finance, and the marketing and investment activities of individual firms. Controversial, in part because perspectives inevitably differ on both the causes and significance of the trade deficit, but also because trade policy usually has to balance strong conflicting interests.

SHIFTS IN THE U.S. TRADE BALANCE

The dimensions of the trade deficit are reasonably familiar to all of us. Measured in the way that it enters our overall balance of payments, the trade deficit averaged $30 billion per year from 1977 to 1982. Last year it grew to $61 billion, and most forecasts suggest it will reach about $100 billion this year (Table 1).

Not as many of us are familiar with how the U.S. trade balance has been shifting in different markets (Table 2). Given the hue and cry about Japanese exports, one would expect to find that our trade deficit with Japan was a leading cause of the widening of our trade deficit. In fact, our deficit with Japan only widened by $4 billion between 1981 and 1983, mainly due to higher U.S. imports.

U.S. trade with other industrial countries has not held up as well as our trade with Japan. Since 1981, our exports to these countries have fallen $15 billion, and our trade balance with them has swung from a $13 billion surplus to an $8 billion deficit last year.

In fact, by far the largest U.S. trade balance deterioration has been with Mexico. Our exports to Mexico have dropped by roughly half since 1981, from $18 billion to $9 billion last year. With rising U.S. imports, our balance with Mexico swung from a $4 billion 1981 surplus to a deficit of $8 billion last year. Adding in smaller declines with other less developed countries, our overall trade balance with non-OPEC LDCs worsened by $22 billion from 1981 to 1983.

Bucking the tide was our trade with OPEC member countries. Driven by forces set in motion by OPEC itself, oil consumption in the United States and other oil-importing countries has continued to plummet, helping to drive down oil prices. The combined impact of these forces has helped trade balances in all oil-importing countries—particularly the United States.

U.S. oil import volume, which had already fallen 32 percent from its peak by 1981, dropped another 17 percent between 1981 and 1983. The average cost of our imported oil also dropped 17 percent, from $34 per barrel to just over $28 per barrel. Most of the reduction in U.S. oil imports came in our imports from OPEC, which dropped by half, from $50 billion in 1981 to $25 billion last year. While OPEC in turn had to cut back imports from the United States by $6 billion, the net impact on our trade balance was still positive by $19 billion.

Trade performance by commodity group has fewer surprises (Table 3). U.S. oil imports dropped by $24 billion from 1981 to 1983. Other imports, which had fallen in the 1982 recession, recovered strongly in 1983 and stood $19½ above their 1981 level. Our exports, in contrast, continued to fall on a year-over-year basis. Agricultural exports in 1983 stood $7½ billion below their 1981 peak, and non-agricultural exports were down $29½ billion.

Taking into account U.S. trade in both goods and services, as well as transfer payments and receipts, the U.S. current account swung from a surplus of $4½ billion in 1981 to a $41 billion deficit last year (Table 3). In addition to the $32½ billion widening of our trade deficit over this period, there was a $1½ billion increase in net U.S. transfer payments abroad and an $11 billion decline in our surplus on net service transactions. This decline came almost entirely through reduced net income on our overseas investments. While we expect some recovery in investment income, next year's current account deficit will likely be in the $70 to $80 billion range.

These are very large figures, both in absolute terms and as a percentage of our Gross National Product. They lend themselves to dramatic rhetoric and calls for urgent action. In my remarks today, I will address a number of important issues which need to be borne in mind by the Congress and by the Administration in reacting to these requests. These issues include the causes of the widening of our trade deficit, the impacts of the deficit on both the American economy and the rest of the world, and our views on the appropriate policy response.

THE CAUSES OF A WIDENING TRADE DEFICIT

In broad terms, there have been three major factors in the widening of our trade deficit. These are: the strength and timing of the U.S. economic recovery; declines in our exports to developing countries which are experiencing financial problems; and the appreciation of the dollar on exchange markets over the past three years. Table 4 gives rough orders of magnitude for the impact of each of these factors.

In the United States, the trough of the last recession came late in 1982. During 1983, our real GNP expanded 6.2 percent—a strong rebound, and about in line with the first year of other recoveries in the postwar era. Real growth in other major industrial countries, in contrast, was only 3 percent last year, and even by the end of the year a sustained upturn was not yet underway in some of those countries. Signs are that a strong U.S. recovery is persisting into 1984, as reflected in our budget forecast of 4.5 percent real growth, while economic recovery will continue to gather steam in most of the major foreign industrial countries this year.

In qualitative terms, the impact of the relatively strong U.S. cyclical position on our trade balance is quite clear: our strong recovery is leading directly to rapid increases in U.S. imports, while growth in our major export markets fails to keep pace. A ballpark estimate for the "growth gap" in our trade balance is $15 to $20 billion this year.

A slow recovery in the industrial world has not been the only problem for U.S. export markets. We are also a major exporter to developing countries—and our trade performance has been strongly influenced by their debt problems over the past two years. The inability of these countries to finance previous levels of imports was the major reason for the 50 percent drop in U.S. exports to Mexico from 1981 to 1983, which I cited earlier, and for the $22 billion deterioration in our trade balance with all non-OPEC LDCs. Similar financial problems in Eastern Europe were reflected in a $1½ billion decline in U.S. exports to that region, as well. Finally, while there is no way to quantify it, LDC debt problems have undoubtedly had an indirect negative effect on our exports to other industrial countries, by lowering their own exports and real growth. Overall, a ballpark estimate of the debt-related part of the widening of our trade deficit would be at least $25 to $30 billion.

Finally, a significant portion of the U.S. trade deficit was also attributable to the appreciation of the dollar on foreign exchange markets. Between the beginning of 1981 and this January, the dollar appreciated roughly 30 percent on a weighted-average basis against other major currencies. Although it has since depreciated somewhat, it takes roughly two years for the full impact of exchange rate changes to be evident in our trade balance. As a result, the exchange rates driving this year's trade deficit will still be mainly those of 1981-1983, when the dollar was appreciating.

Dollar appreciation, to the extent it is not offset by relatively better U.S. inflation performance or other factors which improve our competitiveness, makes it more difficult for U.S. businesses to compete with foreign firms. This is true both in our domestic market, where foreign goods become cheaper for U.S. consumers, and in our export markets, where dollar-priced goods become more expensive in terms of the local currency.

While there is general agreement on the direction of the impacts of exchange rate changes on trade flows, it is much more difficult to pinpoint the *size* of those impacts. There are a number of analytical techniques which can be applied to this issue, which yield significantly different estimates, and in addition small changes in the application of a given technique can produce large changes in the result. Estimates which attribute to dollar appreciation the residual part of the widening of our trade deficit—the part which is not explained by relative growth rates or debt problems—run as low as $25 billion for 1984. At the high end of the range are estimates from simple econometric models which reach as much as $100 billion. There are substantial technical problems with all methods of performing this calculation, and econometric models in particular have poor track records in predicting the impacts of large shifts in economic variables. The most we can say with any confidence is that the truth probably lies in the $25 to $100 billion range.

EXCHANGE RATE DEVELOPMENTS

There are many who would argue that, regardless of how large or small the impact of dollar appreciation actually is, it has been artificial and unhealthy. Thus, we are told that the dollar has been driven up unnecessarily by an excessive U.S. budget deficit and high U.S. interest rates. We are offered precise calculations of the degree to which the dollar is "overvalued"—figures typically ranging from 20 to 30 percent.

On balance over the last three years, the dollar appreciated substantially against all major currencies—yet interest rate differentials moved against the dollar. Between the beginning of 1981 and the end of last year:

The dollar appreciated by 38 percent against the German mark, 83 percent against the French franc, and 14 percent against the Japanese yen;

While interest rate differentials moved *against* dollar assets, by 5 percentage points for Germany, over 9 percentage points for France, and nearly 6 percentage points for Japan.

There is a similar pattern in the recent depreciation of the dollar. Since its mid-January peak:

The dollar has dropped 9 percent against the German mark, 8 percent against the French franc, 4 percent against the British pound, and 4 percent against the Japanese yen;

While interest rate differentials vis-a-vis all other major industrial countries have moved in favor of the United States.

A more meaningful economic argument can be made linking high real interest rate differentials with a strong dollar. It is notoriously difficult to measure real interest rates, given the central role played by inflation expectations in determining the real interest rates perceived by investors. Work we have done at Treasury suggests that there has been little correlation between movements in real interest rates and real exchange rates. However, all such empirical work is very sensitive to the means chosen to approximate expected inflation rates in the United States and the other major industrial countries, and it is possible to obtain a wide variety of differing estimates.

More fundamentally, both the appreciation of the dollar over the past three years, and its recent depreciation, reflect the normal working of the international adjustment process. The concept that the dollar has become "overvalued" is intuitively appealing, but a poor guide to economic policy. Most estimates of the degree of dollar "overvaluation" are based on the assumption that the exchange rate between any two countries should move only to offset differing national inflation rates, so as to keep the international price-competitiveness of traded goods unchanged.

Decades of economic research, however, have failed to verify this simplistic "purchasing power parity" theory of exchange rate determination. This should not be too surprising, since it is only designed to explain one dimension of the behavior of merchandise trade—which in turn is only a small part of total international transactions. The vast bulk of transactions in the foreign exchange markets are capital transactions, and the dynamics of the foreign exchange market reflect that fact.

International investors act on their perceptions of where real after tax rates of return to capital will be highest, and they constantly weigh the relative attractiveness of assets denominated in different currencies. Thus, when investors sense that there are current or prospective developments which will significantly alter relative rates of return to capital, they react accordingly. Over time, the resulting international capital flows help to achieve a more efficient allocation of resources.

The major factors influencing market perceptions of real rates of return to capital over the past three years have been: fundamentally better U.S. economic performance and prospects; weaker performance and prospects in other major industrial countries; and the threat posed by economic and political turmoil in the Middle East, Latin America, and Eastern Europe. Our economic program brought a historic turnaround in U.S. inflation performance, followed by vigorous recovery. As a result of our non-inflationary recovery, deregulation, and more favorable depreciation allowances under the Economic Recovery Tax Act of 1981, the profitability of American business investment has improved dramatically. Foreign economic prospects and business conditions, especially in Europe, did not keep pace with ours. And in many troubled parts of the globe, concerns over possible expropriation, capital controls, or physical destruction of assets led to "safe haven" capital flows into the world's strongest and most stable country.

Under those circumstances, there was nothing we should—or could—have done to keep the dollar from appreciating, short of weakening our own economy to match the rest of the world. Similarly, we see no reason to be concerned about the recent orderly depreciation of the dollar. Several of the factors which have been pushing the dollar up are now shifting. International investors may be recognizing that the most rapid and dramatic improvements in the U.S. economy have already happened, and that many other industrial countries are catching up. Similarly, the historic turnaround in U.S. inflation performance has largely run its course for now, and we are entering a temporary period of slightly higher inflation rates. Finally, at some point currency depreciation in response to a widening current account deficit is a normal part of the international adjustment process. Over time, dollar depreciation should help to moderate both the U.S. trade and current account deficits and foreign surpluses.

IMPACTS ON THE U.S. AND GLOBAL ECONOMY

Despite occasional assertions to the contrary, a widening U.S. trade deficit has not been an unmitigated disaster for either the United States or for the rest of the world. For each there are both gains and losses, and trade developments cannot be judged in isolation from other economic developments and policies.

In the United States, there can be no question that firms in our traded-goods industries are finding life more difficult. Particularly as a result of dollar appreciation, they must cut costs (and in some cases profit margins) in order to compete with foreign goods in both our domestic market and in markets overseas. One result may be that the direct impact of the deficit will be to make output and employment in these industries lower than it otherwise might have been. However, it should be remembered that the widening trade deficit is, to a large extent, an indirect result of our success in cutting inflation and revitalizing the American economy. The benefits of our policies and our non-inflationary recovery have helped to offset negative impacts of a bigger trade deficit, not only for the economy as a whole but also for traded-goods industries. Profit reports, stock market results, and productivity and employment gains in U.S. manufacturinig industries do not seem to indicate a "deindustrialization" of America.

In addition, for American consumers as a group there are significant gains from a lower cost of imported goods, which leads directly to lower inflation and increased real buying power. Greater foreign competition impacts indirectly on our inflation rate, as well, by keeping the pressure on U.S. firms for lower costs, greater efficiency, and lower prices. Service industries, which compete primarily for domestic sales against other U.S. firms, reap the benefits of lower inflation and thus tend to have rising output and employment.

Some analysts have complained that the strong dollar and widening trade deficit are causing the current U.S. recovery to be "unbalanced" and therefore unsustainable. I don't think the facts support this claim. As indicated in Table 5, not only was our 6.2 percent real GNP growth rate during 1983 about in line with growth at the same stage of previous recoveries, but the pattern of that growth was healthy. Consumer spending (particularly durables purchases), housing, business investment, and even exports all made greater contributions to this recovery than in previous ones. Weaker than average contributions came from Federal, State and local government spending and from *net* exports. What is particularly striking is that interest-sensitive categories all made greater-than-average contributions to the recovery—and that business investment, which is so crucial to sustained growth, is booming most of all.

For the rest of the world, the impacts of our trade deficit are in many ways a mirror image of impacts on the United States. Traded goods industries in other countries gain output and employment; there is also a temporary upward pressure on foreign inflation rates from higher import costs. Trade gains with the United States have probably been a significant factor in helping to solidify the hesitant economic recovery in Europe. In the longer run, improved trade balances in less developed countries are necessary to enable them to service their debt in an orderly manner, and for these improvements to take place there must inevitably be a counterpart swing toward deficit among their trading partners. Our widening deficit is thus clearly facilitating the economic adjustments which financially troubled developing countries must make to resolve their international debt problems.

The charge is sometimes made that a large U.S. trade and current account deficit causes the United States to "drain capital" out of the rest of the world, thereby damaging other countries. In balance of payments accounting, it is undeniably true that a current account deficit must be paralleled by transactions of equal size, and opposite sign, elsewhere in the balance of payments. These parallel transactions are usually thought of as being capital transactions, so that a U.S. current account deficit by definition would mean there is also a net capital inflow to the United States.

There are a number of fundamental problems with the "draining capital" accusation, however. The first is the influence of the statistical discrepancy, as clearly reflected in U.S. capital account data for 1982 (Table 6). Our 1982 current account deficit of $11 billion might have implied an $11 billion net capital inflow, if there were no statistical discrepancy in our balance of payments. However, in fact there was a recorded net capital outflow of $30 billion in 1982, and the accounts were balanced by a positive statistical discrepancy of $41 billion. By definition, we do not know what sorts of transactions contributed to the discrepancy—and while the possibilities for measurement error and reporting gasp are probably greatest in the capital account, the existence of a large discrepancy casts some doubt on all of our balance of payments data.

A second basic flaw in the "draining capital" argument can be seen in the 1983 data. Last year the statistical discrepancy was rather small ($7 billion), so our $41 billion current account deficit was reflected mainly in recorded net capital inflows, totaling $34 billion. However, the 1982–83 swing from net capital outflows to net inflows was not the result of higher inflows of foreign capital to the United States: these inflows actually fell by $5 billion, from $88 billion in 1982 to $83 billion last year. What caused a net inflow was that outflows of U.S. capital fell by even more—by $69 billion. U.S. investors, and particularly U.S. banks, reduced their foreign lending dramatically, while foreigners also invested somewhat less in the United States.

The third flaw is the issue of causation. Since the balance of payments must, be definition, balance, a current account deficit can only occur in conjunction with a net capital inflow (disregarding the significant problem of the statistical discrepancy). However, one cannot legitimately say that the current account deficit "caused" the capital inflow. It would be just as easy to say that increased demand for U.S. dollar assets, as reflected in the capital account, has forced us to run a current account deficit. The fact is that all of the transactions recorded in our balance of payments accounts are simultaneous reflections of U.S. and foriegn economic conditions, in the ways I have discussed earlier.

THE U.S. POLICY RESPONSE

As is probably clear by now, we do not believe that the widening trade deficit should precipitate major change in U.S. economic policy. Some of the measures which are urged on us are impractical or even counterproductive. In addition, we believe that forces are already in motion—both through government policy actions to strengthen foreign economic performance and manage debt problems, and through the working of the international adjustment process—to address the major causes of our widening deficit.

One set of policy responses which we have consistently rejected is direct action to drive down the dollar's exchange market value. As was demonstrated by the thorough international study of foreign exchange market intervention carried out between the Versailles and Williamsburg Summits, intervention does not have a significant or lasting impact on exchange rates. Attempts to use intervention to permanently alter exchange rate levels are doomed to failure.

If intervention sales or purchases are done in such a way that they are permitted to alter the course of domestic monetary policy—that is, if they are "unsterilized" in the technical jargon—they can have a lasting impact. However, this can be a misleading way of looking at what is really going on in such a case: the factor which would alter exchange rate behavior would be that there had been a change in monetary policy, not that it had taken place in connection with intervention. There is no doubt that we could drive down the dollar very rapidly by reigniting rapid inflation through excessive money growth—but I cannot seriously believe that the American people want to undo all we have done to bring inflation under control and revitalize our economy. Furthermore, while we would quickly reap the disastrous results of excessive monetary expansion in our domestic economy, the positive effects of dollar depreciation on our trade balance could take roughly two years to reach their full extent, as I noted earlier.

Some observers have suggested that we use capital controls to force down the dollar. I suspect even the proponents recognize that imposing capital controls would be a self-destructive act, and are only suggesting them for dramatic effect. In brief, I would note that capital controls the United States has tried to use in the past have not worked particularly well. More fundamentally, to the extent that new U.S. controls did work they would have major negative impacts on domestic and international capital markets, could lead to interest-rate increases and sectoral credit shortages, and would undermine the longer-term confidence of international investors in the U.S. dollar as a transactions currency and the U.S. economy as a place to invest.

There have been proposals over the past year to "correct" the U.S. trade deficit, and to modify the impact of foreign competition on U.S. industries, by restricting foreign access to the U.S. market or by subsidizing U.S. exports.

The push for market protection is not new. Protectionist pressures always increase in an economic recession, in response to increasing unemployment and reduced production at home. Once the domestic market has turned around and has begun to expand once more with economic recovery, we would logically expect these pressures to subside. But in practice, they usually don't. The reason: in the initial stages of recovery, imports often grow faster than exports, unless recovery is global and simultaneous.

The strong pace of U.S. recovery, in advance of recovery in our major foreign markets, has increased demand for both domestic and foreign goods in the U.S. market. A surge in imports, per se, therefore, should not be read as damaging to competitive U.S. industries. As I noted earlier, the rise in imports is in large measure a reflection of successful U.S. policies and a noninflationary recovery which is benefitting all American citizens and industries.

Protectionism is not cost-free by any means. Its drawbacks are clear and well known to you. But let me summarize them briefly. Protectionism can have a serious impact on other sectors of the U.S. economy through a general increase in inflation, higher prices to industries dependent on the protected imports, and the risk that the countries affected by the import restraints will retaliate.

These drawbacks certainly apply to surcharges or quotas imposed under the authority of Section 122 of the Trade Act of 1974. An import surcharge or quota would increase inflation, be likely to lead to retaliation by our allies, and cut the ground from under U.S. efforts to restrain protectionism by other countries. Such an outcome could deal a serious blow to the non-inflationary world recovery now developing.

A general surcharge, furthermore, might well be offset by a corresponding appreciation of the dollar, leaving our competitive position unchanged. Alternatively, under some circumstances it could be viewed as a reckless, panic reaction which could weaken confidence in the U.S. economy and U.S. leadership. In either event, use of Section 122 authority would be inappropriate and counterproductive.

While the United States did impose a surcharge on imports in 1971, the situation then was very different. In contrast with our current flexible rate system in which exchange rates adjust continuously to changing economic conditions, exchange rates in 1971 were fixed, and it was not possible to get serious negotiations underway despite the fact that rates were clearly out of line with the underlying fundamental economic situation in major countries. A dramatic measure was needed to begin serious negotiations on exchange realignment—and the surcharge was subsequently removed within months.

Nevertheless, U.S. industries do have a legitimate right to seek redress from unfair foreign practices such as the use of subsidies benefitting exports and foreign dumping. This Administration will continue to actively enforce our countervailing duty and antidumping laws, as we have in the past.

Where individual industries are being hurt by surging imports, they can request import relief under our trade laws. Several cases are now pending under these provisions. They will be decided on their merits on a case-by-case basis.

On the export side, the Administration has been concerned about the impact of foreign export subsidies, especially in the agricultural area, on our ability to compete in third markets. We have directly subsidized exports to individual markets such as Egypt to bring this point home and are working both bilaterally with the European Community and multilaterally within the GATT. We are prepared to continue such selected subsidies, as necessary.

However, we do not see a need for broad export subsidies for all U.S. exports, to "offset" the impact of the strong dollar. Such subsidies would be extremely costly to the Treasury at a time when we need to sharply reduce Government expenditures. They could spur foreign imposition of countervailing duties. And they could set off an escalation of disruptive trade competition that will benefit no one.

In conclusion, I would urge the Congress to resist pressures to respond to the widening of our trade deficit with measures which would be harmful to our own broader national welfare. While it is unfortunate that impacts of increased competitive pressures from foreign goods are not always as evenly distributed among our citizens as are the benefits of our non-inflationary recovery, we must remember that the deficit is, to a large extent, an indirect result of our success in revitalizing the American economy.

As economic recovery abroad catches up with our own, as developing countries come more fully to grips with their debt problems, and as the international adjustment process brings an exchange market response to diverging external positions among the major industrial countries, we expect the deficit to begin declining again over time. In addition, where there are restrictions on access by U.S. firms to foreign markets for goods, services, or capital, we will continue to press for a more open system.

TABLE 1.—U.S. TRADE BALANCE, 1977–84 [1]

[In billions of dollars]

	1977–82 average	1982	1983	[2] 1984
Exports	187	211	200	205
Imports	–217	–248	–261	–305
Balance	–30	–36	–61	–100

[1] Trade date on balance of payments basis.

[2] Treasury projection for 1984.

TABLE 2.—SHIFTS IN U.S. TRADE BY COUNTRY OR COUNTRY GROUP, 1981–83 [1]

[In billions of dollars]

	1981	1983	Shift
Trade with Mexico:			
U.S. exports	18.2	9.1	−9.1
U.S. imports	−13.8	−16.8	−3.0
Balance	4.4	−7.7	−12.1
Trade with other non-OPEC LDCs: [1]			
U.S. exports	49.7	46.4	−3.3
U.S. imports	−53.1	−60.4	−7.3
Balance	−3.5	−14.1	−10.6
Trade with Japan:			
U.S. exports	21.8	21.7	−0.1
U.S. imports	−37.6	−41.3	−3.7
Balance	−15.8	−19.6	−3.8
Trade with other industrial countries:			
U.S. exports	120.1	105.3	−14.8
U.S. imports	−106.7	−113.0	−6.3
Balance	13.4	−7.8	−21.1
Trade with East Europe:			
U.S. exports	4.4	2.9	−1.5
U.S. imports	−1.6	−1.4	0.2
Balance	2.9	1.5	−1.3
Trade with OPEC:			
U.S. exports	21.1	15.1	−5.9
U.S. imports	−49.9	−25.2	24.7
Balance	−28.8	−10.0	18.8

[1] All data on balance of payments basis, except trade with "other non-OPEC LDCs" which is on roughly-comparable Census Customs-value basis.

TABLE 3.—U.S. TRADE AND CURRENT ACCOUNT BALANCES, 1981–83

[In billions of dollars]

	1981	1983	Shift
Exports:			
Agricultural	44.0	36.6	−7.4
Non-agricultural	193.0	163.6	−29.4
Imports:			
Oil	−77.8	−53.8	24.0
Non-oil	−187.3	−206.9	−19.7
Trade balance	−28.1	−60.6	−32.5
Net investment income	33.5	23.6	−9.9
Other net services	6.1	4.8	−1.3
Net transfers	−6.9	−8.6	−1.7
Net invisibles	32.7	19.8	−12.9
Current account balance	4.6	−40.8	−45.4

TABLE 4.—SHIFTS IN U.S. TRADE BALANCE, 1981–84

[In billions of dollars; balance-of-payments signs]

	1981	1984	Change
Exports	237	205	−32
Oil imports	−78	−60	+18

TABLE 4.—SHIFTS IN U.S. TRADE BALANCE, 1981–84—Continued

[In billions of dollars; balance-of-payments signs]

	1981	1984	Change
Non-oil imports	−187	−245	−58
Trade balance	−28	−100	−72
Trade balance excluding oil imports	50	−40	−90

Note: Estimates of contributions to shift in trade balance:
U.S. cyclical position: −15 to −20.
Internaitonal debt problem: −25 to −30.
Dollar appreciation: −25 to −100.

THE BALANCED NATURE OF THE CURRENT EXPANSION

As the table shows, the current expansion has been remarkably well balanced, rather than distorted by high interest rates as some had feared. Above-normal gains have been made in the interest-sensitive areas of spending on consumer durables such as autos and appliances, as well as in business capital spending and housing. The trade balance has been weak but exports have risen rather than remaining flat as in the first year of the average of previous expansions.

TABLE 5.—DISTRIBUTION OF REAL GNP GROWTH DURING THE FIRST YEAR OF EXPANSION

[As percent of total]

	Average of five previous expansions	Current expansion
Consumer spending	52.3	57.3
Durables	19.3	24.0
Business capital spending	7.6	21.9
Housing	15.2	16.6
Inventories	26.4	34.2
Federal purchases	−2.8	−8.7
State and local purchases	7.5	0.8
Net exports	−6.0	−21.9
Exports	0.6	4.5
Imports	−6.4	−26.5
Memo: Total growth in real GNP in percent	6.8	6.2

TABLE 6.—U.S. CAPITAL ACCOUNT, 1982–83

[In billions of dollars]

	1982	1983
Recorded inflows of foreign capital to United States	88	83
Minus recorded flows of U.S. capital to other countries	−118	−49
Equals net recorded capital	−30	34
Plus statistical discrepancy	41	7
Equals net recorded capital plus discrepancy	11	41
Current account deficit	−11	−41

Chairman GIBBONS. Let me call your attention to the charts over here to your right. I am not sure whether your glasses will focus on that, but the one to the left of the two charts is the one showing the dip in the merchandise balance of trade showing a current annualized projection of around $100 billion. The chart to the right is, of course, the current account chart.

I have maybe one, two, or three questions. My first question would be, is it desirable that we try to move that red line up toward the zero line and bring the red bar graph up toward the zero line concurrently? Is it desirable that we do it?

Do you think the Congress should be doing that now?

Mr. SPRINKEL. I think the markets are doing it.

Chairman GIBBONS. So I would infer that your answer is we ought to leave the markets alone and let them do it?

Mr. SPRINKEL. Yes, sir, because sometimes doing nothing is much to be preferred to doing something that harms the American economy and the American consumer.

Chairman GIBBONS. You feel that the markets without our intervention will move us back toward that zero line and that would be desirable?

Mr. SPRINKEL. Yes, sir, I do not expect to make progress this year, as I indicated. The lag unfortunately on adjustments to get the full impact is 2 years. To get any significant impact at all, we are talking about a year. So it would be very late this year or early next year before we can begin to see some benefits from the recent depreciation in the dollar.

Chairman GIBBONS. Your answer has made my job a lot easier for the rest of this year, if I follow your advice, which I appreciate.

I was going to ask you what we should do if your suggestion was we should come back toward the zero line and I think you answered that in my first question—as you said, let the market do it, without congressional or governmental intervention at this time.

Mr. SPRINKEL. Yes, sir.

Chairman GIBBONS. All right. Well, now that my job is so much easier, I will turn it over to Mr. Jenkins.

Mr. JENKINS. That almost eliminates my questions, but let me ask one question. You indicate that part of the problem of the trade deficit is attributed to the debt difficulties of the LDC.

Mr. SPRINKEL. Yes, sir.

Mr. JENKINS. If I recall your testimony correctly, you indicated some $25 to $30 billion is in the ball park.

Mr. SPRINKEL. Yes, sir.

Mr. JENKINS. The debt problems that these countries face which is restricting their purchasing power from our markets or any other countries' markets, they are simply unable to purchase as they would normally. The actions of our attempting to force, as the terms originally called for, the interest payments and so forth is hurting our balance of trade in the amount of some $25 or $30 billion.

Is that correct?

Mr. SPRINKEL. Our best guess is the debt problems are accounting for that magnitude of the deficit. I think it is not correct to say that creditors insisting on being paid by debtors is causing that problem.

In general, we expect debtors to pay their debt and to adjust their economic policies in a way that makes it possible for them to pay their debts. That is whether it is international or domestic.

Mr. JENKINS. Of course, one way for a bank to do that, would be to classify the loan, and to begin writing off part of it or making new arrangements. Is that correct?

Mr. **Sprinkel.** Of course they are writing off some of the debt. There are some countries that are behind payments and when they get too far behind some of the debt has to be written off. Nonetheless I think it is fair to say that, given the IMF programs that have been adopted by the various countries, that the banks and the governments, especially the debtor governments have been quite cooperative.

Additional credit has been provided so that the pain of the adjustment which was brought on by prior poor economic policies in those countries has been less. Hence, the effect on our export sales has been less than would have been the case if we had had no adjustment process under the IMF aegis.

Mr. **Jenkins.** I think a lot of our banks have a problem in not being able to accrue interest on some of these loans and it makes their statements look terrible if they were unable to accrue this interest and show it as a return. That makes their stockholders nervous and it makes the board of directors and the CEO's a little bit mad.

They are very reluctant to do that, aren't they, Mr. Secretary, from a natural survival standpoint?

Mr. **Sprinkel.** Many banks, I am sure, wish they had not been heavily involved in extending credit to the various debtor countries. That was a mistake. The question is, what do you do now?

Mr. **Jenkins.** Could we do anything by changing the requirements on some of these entries that have to be made on the bank statements before a loan is classified? Could we modify in any way without destroying the faith that we have in things to alleviate this problem and help recoup some of this $25 to $30 billion that we are losing in the balance of trade?

Mr. **Sprinkel.** I do not believe it would be productive to bend our rules. That is, under the rules, if interest is not being paid for a particular period they have to back out those earnings. They cannot count it as earnings if they are not getting paid. And we expect those rules to be enforced, as a matter of discipline, to be enforced in the future as it has been in the past.

I do not believe that changing those rules would be a productive way to encourage discipline in the banking system in the future. I think it would be counterproductive from that point of view.

Mr. **Jenkins.** If many of these loans this year became classified loans and cannot be carried as a productive asset, what will that do to the banking institutions?

I keep hearing horror stories on both sides. If they had to classify these loans and write them off, what would happen to the banking industry?

Mr. **Sprinkel.** Well, it would reduce their reported earnings and also reduce their net worth.

Mr. **Jenkins.** I am not nearly as concerned about that if we don't have a panic.

Now, do you think we are going to have bank failures across the country if that occurs?

Mr. **Sprinkel.** We feel very confident that the international strategy which we formulated some 2 years ago, an internationally agreed-upon strategy, is working pretty well, though not perfectly.

We do not expect to see widespread bank failures, but that is not to say that some banks won't take a rap in earnings. They will.

Mr. JENKINS. I want to ask one other question, Mr. Chairman. You indicated that the imbalance with Japan had risen, I believe, only $4 billion.

Mr. SPRINKEL. Yes, sir, it is a rather surprising result that stands out if you look at the numbers; at least it was to me.

Mr. JENKINS. Does that necessarily indicate the lack of a problem? What I am thinking is maybe Japan is replacing in other markets some of our natural exports?

Mr. SPRINKEL. We do believe there is a problem even though it is not emphasized by that particular trade number.

The U.S. Government is in the process of very strenuous negotiations with the Japanese on two fronts. One is to liberalize the trade policy, to make possible more exports by U.S. producers to the Japanese markets which are, in our opinion, unduly, unfairly restricted.

Mr. JENKINS. Are we making progress there?

Mr. SPRINKEL. Well, it is too early to be certain but I am still hopeful.

On the second front, which I have been directly involved in, is very strenuous negotiations to open up their capital markets. That, in my opinion, if we succeed will have a longer run effect of raising the yen vis-a-vis the dollar and certainly increasing the efficiency of the Japanese economy as well as the world economy. So we are working very hard to open up those capital markets.

Prime Minister Nakasone agreed with President Reagan in the latter part of last year to move in that direction. We believe progress will be forthcoming but it is not easy.

We are not interested in promises tomorrow or the next day or the next year; we are interested in action. And I hope to see some over the next very few months.

Mr. JENKINS. Ambassador Brock indicated that that progress has not been occurring recently. You don't have any information to dispute that, do you?

Mr. SPRINKEL. No, sir, I do not. Secretary Regan indicated when we were in Japan recently that we are very unhappy with the response so far of the Japanese Government with respect to opening capital markets. That is not to say we are not going to make some progress, but if we had to say up to now how much progress has been made, I have to say not much.

Mr. JENKINS. The best thing I can assume is that the Congress must do absolutely nothing right now in attempting to address this.

Mr. SPRINKEL. I would certainly urge you not take direct action in terms of trying to artificially deter imports or artificially subsidize exports because, in my opinion, the costs would be greater than the benefits.

Mr. JENKINS. It would be easier for us to finance unemployment compensation and trade adjustment relief economics to take care of the displaced unemployed temporarily?

Mr. SPRINKEL. Well, I am very pleased at what is happening to our employment. In contrast to Western Europe, not only are we making big gains on employment now and over the past 15 months, but over the last decade we have done quite well.

The European Community, for example, has created no private jobs. In fact, they have had a slight loss in private jobs over the last decade. In our case we have created over 24 million and we are adding to it each and every month.

So to say we are not performing on the employment front, I think, is to ignore reality. We can undoubtedly do better but we are getting major strides forward and I hope we can keep it that way.

Mr. **Jenkins**. Thank you, Mr. Chairman.

Chairman **Gibbons**. Thank you, Mr. Jenkins.

Mr. Crane, do you have questions?

Mr. **Crane**. Yes. Thank you, Mr. Chairman.

Mr. Secretary, I have a couple of questions on our relationships with Japan. Maybe you don't have these figures, but if you could subsequently provide them, I would appreciate it.

One, do we know the volume of business done by American corporations in Japan, what their earnings were and what the earnings were of Japanese business in the United States?

The reason I asked that is I saw some figures that came out of a joint study last year of Japanese and American business that indicated that we enjoyed a rather substantial advantage in that area.

Another question deals with the dollar volume of oil imported by Japan that is not counted in the trade figures because they are American corporations. The purchases are coming from other countries. They are American oil companies.

I saw figures that amounted to about $21 billion. I believe those figures were for 1982.

Then the third question is the percentage of Japan's gross national product that they import from us versus the percentage of our gross national product that we import from Japan.

Again, the figures I saw indicated that Japan was importing, as I recall, 1.9 percent of its GNP from us and we were importing 1.3 percent of our GNP from Japan.

The reason I would like to try to get verification of the figures is I think it puts the trade relations with Japan into a different perspective than is frequently dramatized because of the fairly substantial imbalance in the trade figures that are routinely published.

Then, another question in your testimony you indicated that one of the ways in which we were hurt in trade last year was with Mexico. And the IMF, as a condition for extending additional loans to governments, imposed restrictive policies on those countries with regard to imports.

How much of that trade imbalance was dictated, vis-a-vis Mexico, by the IMF?

Mr. **Sprinkel**. Let me take the last one first. Most of the drop in Mexico's imports from the United States occurred before the program actually got into effect, and the reason was that they ran out of money. They have pursued highly inflationary policies, as you know, over the past decade. Their economy was not performing well. Their peso had frequent devaluations, and clearly something had to be done if economic health was to be restored.

Now fortunately from my point of view, we have a very responsible government in Mexico, including the President and the Finance

Minister who are directly involved in most of those policies. They are making the necessary changes. There has been enormous improvement in Mexican reserves. They are now beginning to increase their imports. Their exports have performed extremely well.

I think Mexico has been sort of a star pupil in terms of how it has conducted its affairs, with the help of the IMF, obviously at one time with the help of this Government and other governments, and with the help of the commercial banks. Banks are thinking much more highly of their credits now because the risks are less and, therefore, the spreads are being reduced.

We have done some work on several countries that have gone into IMF programs. As a general matter, countries under IMF programs usually have better real GNP growth performance and higher import growth than would have been possible without an IMF program—their policies are sounder, and they get access to private and official financing which would otherwise be unavailable. Thus, far from forcing them to reduce imports from the United States, the IMF usually makes possible higher U.S. exports to those countries.

In addition, IMF programs always forbid the imposition for balance of payments reasons of new import restrictions. Most recent programs go much farther than this in fostering trade liberalization: the vast majority include provisions for the reduction or elimination of existing import restrictions and export subsidies.

We are very pleased with Mexican progress. They don't have an ambitious target of growth this year. I think one-half of 1 percent is their expectation, but they are absolutely dedicated to avoiding going back to expansionary policies which got them into trouble in the first place. And they believe if they pursue a policy of restraint through this period that in the years ahead they will be able to resume their growth pattern, and I also believe that.

Mr. **Crane**. One final question, if I may, Mr. Secretary. I have heard and would like to know if it can be verified that Argentina, I believe Brazil and Venezuela are neither servicing their debt at the present time—they are not even paying interest on their outstanding international obligations, much less paying on the principal, is that correct?

Mr. **Sprinkel**. The Argentineans are behind in their payments. The Venezuelans are behind in their payments. I think the Brazilians have caught up because there was a sizable package, as you know, brought together under the new IMF program, and I will be glad to check it, but I think they are current in terms of paying their interest.

Mr. **Crane**. Mr. Secretary, if, say, a sizable American bank with a limited exposure in Venezuela were to make the declaration that that country is in default, what might that trigger with regard to other banks that had a more substantial exposure in those countries? And I can think of some competitive reasons why someone might want to do that. But what would be the ramifications?

Mr. **Sprinkel**. Well, it would be serious. That is why it is important that those countries get current. In Venezuela's case, they have sizable reserves, as you know. They are not out of money in the sense that some of the other governments were at the time they moved behind on their interest payments. And we are hopeful that in the reasonably near future, the Venezuelans will move to get their payments current.

They have not, as you know, adopted an IMF program, and that is not the most serious thing in the world. But they also haven't brought about the adjustments on their own. So I am hopeful that we will see some good signs there in the months ahead, but we are not certain of that.

Mr. **Crane**. I thank you, Mr. Secretary. You were my candidate and still are for Federal Reserve Board Chairman.

Mr. **Sprinkel**. Thank you, Congressman Crane, and we will get you the data on those first three questions. I do not have them on the top of my head.

[The information follows:]

ANSWERS TO CONGRESSMAN CRANE'S QUESTIONS

1. What is the volume of business done by American corporations in Japan. Specifically what are the earnings of U.S. firms in Japan, and what are the earnings of Japanese companies in the U.S.?

Answer: This information is not available through normal government data collections. The McKinsey report, a private-sector study on U.S.-Japan economic relations completed in early 1983, reported that the earnings of the top 15 foreign-affiliated companies in Japan were $2 billion in fiscal year 1981. Of this group, 13 were affiliated with U.S. investors. Their total pre-tax profits came to $1.4 billion. (The Government of Japan defines a foreign-affiliated firm as one with 25 percent foreign participation of the top thirteen U.S.-affiliated firms in Japan, four are wholly U.S.-owned.)

2. What is the dollar volume of oil imported by Japan from third world countries that is sold by American corporations?

Answer: Again, this company-specific data is not collected by the Federal Government. The McKinsey study reported a figure of $21 billion for 1980.

3. What is the percentage of Japan's GNP accounted for by imports from the U.S. and the percentage of U.S. GNP reflected by imports from Japan? Wasn't 1.9 percent of Japanese GNP accounted for by U.S. goods and 1.3 percent of the U.S. GNP reflected imports from Japan?

Answer: The figures cited above also came from the McKinsey report and were developed on the basis of 1981 data. For 1982, Japanese imports from the U.S. equalled 2.3 percent of Japanese GNP, while U.S. imports from Japan remained at 1.3 percent of U.S GNP.

Chairman **Gibbons**. Thank you.

Mr. Pease.

Mr. **Pease**. Thank you very much.

Mr. Sprinkel, in talking about the balance-of-trade deficit, you outlined three factors, the fact that our recovery is proceeding faster than others, the debt problems of some of the LDC's and the strength of the dollar.

Mr. **Sprinkel**. Yes, sir.

Mr. **Pease**. You did not mention at all the basic ability of U.S. industry to compete with industry around the world. Do I understand that you feel that U.S. industry is fully able to compete with Japanese and Germans and so on if some of these other problems are addressed?

Mr. **Sprinkel**. Well, the stronger dollar, of course, does change the ability of U.S. industries to compete, and it increases their costs vis-a-vis costs of production abroad. There have been individual companies and certainly industries that have been severely impacted, and we are well aware of that.

It has, in many cases, some favorable effects as well. That is it has forced more cost cutting or cost consciousness on the part of our own companies, although it has also forced some unemployment. That is one of the costs of this adjustment process which has been offset by certain benefits, which I mentioned previously, but we should not ignore the fact that the stronger dollar has made it very difficult for some of our industries that enjoyed a better competitive situation several years ago to compete with producers abroad.

Mr. **Pease**. Perhaps I didn't make myself clear. When I talk about our industries being able to compete with those in other countries, what I am inquiring whether you are satisfied that the basic efficiency of American industry is such that it can compete, that we do not have a problem of inefficient plants or overpriced labor, or poor management, or that sort of thing?

Mr. **Sprinkel**. I think the situation has improved in the past 3 years. It has improved in several senses. One, productivity has risen very substantially in contrast to a period of many years when productivity in U.S. industry, as we measure it—and we don't measure it very well—showed no improvement. That was partly due to efforts on the part of management, and I am sure partly due to efforts on the part of labor.

We also have seen during this period of disinflation, in which we brought our inflation right from 12 to 14 percent down to 4 or 5, a much slower rate of increase in wage costs, and in some particular industries actually negative numbers, that is wages have come down. Clearly, in some of our industries that previously had been very important, and I think will be important again. Wage rates got well out of line with wage rates in other industries in the United States and also with respect to wage rates abroad, and there has been some realignment.

And the final point is that we are now seeing a very substantial rise in capital spending. I certainly hope it continues because one of the most important ways in which we can further improve productivity of industry is to encourage savings and investments in the United States. And I think at the moment, those trends are quite favorable.

Mr. **Pease**. I would like to talk next about deficits. You mention in your testimony that it is very important that we make a determined effort to reduce future budget deficits.

Mr. **Sprinkel**. Yes, sir.

Mr. **Pease**. According to the Congressional Budget Office, the deficits over the next 3 years approach $700 billion and the deficit reduction package agreed to by the administration is something less than $150 billion.

Do you think that that is making an adequate impact on future budget deficits?

Mr. **Sprinkel**. It is certainly much better than nothing.

Mr. **Pease**. That is agreed. That is not the question.

Mr. **Sprinkel**. And I am very pleased at what has been happening between the administration and the Congress over the past several weeks. The real reason long run to get the deficit down, of course, is to avoid absorbing savings being generated in the private sector of the economy for use in financing the deficit. One of my jobs is to finance that deficit, and we sell a lot of debt. We would like to reduce that absorption of savings so that it can move into capital spending.

However, it is very important, in my opinion, to recognize that it makes a difference as to how you go about reducing that deficit. I personally think it would be highly counterproductive to include substantial increases in tax rates as a device for getting the deficit under control, and I say that for two reasons.

One, it would negate the major efforts made by the Congress and administration over the past few years to encourage savings, encourage investment, and encourage work by reducing marginal tax rates, and I don't want to see that eliminated. That is, supply side economics is well and alive in this country, and we want to keep it that way.

The second reason is that having read about and watched how democracies work, and I am glad we have a democracy, I am convinced that the higher the revenue flows into this country, the higher the level of Government spending so that we would be kidding ourselves to say that a big tax increase will cut deficits commensurately.

Consequently, I think it is very important that the Congress focus on restraining growth in Government spending. We have agreed, as you know, to include some tax adjustments. You can call them whatever you want, loophole closings, or any other phrase that appeals, but they do not represent increases in marginal tax rates which are the ones that most adversely affect incentives.

Now I don't want to argue that any kind of tax increase doesn't have an adverse effect on incentives. I think it does, but there are some that have a more adverse effect than others. So, yes, it is important that we get the deficit down. If we can come out with the compromises that I understand are underway, I think it is a major contribution this year, especially in an election year.

I know it is difficult to take these actions at a time like this. That doesn't mean we have solved a problem. That means we have made a good start, and I am hopeful in the years ahead we can move further in the direction of restraining spending. There has been a sharp increase of allocation of resources to Government which have moved from the 20- to 25-percent range of GNP, and a fairly stable trend in revenue which has held at around 19 percent plus or minus a little bit for many years. It is higher spending that caused the problem.

And, therefore, I would like to see the reversal made in the same direction of restraining spending.

Mr. **Pease**. Would you like to reverse that spending over the last 2 years, which has been the major component of the increase in spending—that is defense spending?

Mr. **Sprinkel**. We are talking about the Federal Government?

Mr. **Pease**. Yes.

Mr. **Sprinkel**. I would like to, but I am not so foolish as to believe that we are going to cut Government spending.

Mr. **Pease**. We are talking about defense spending?

Mr. **Sprinkel**. No, sir, I did not talk about the components. As you know, the President has indicated he had some willingness to slow the rate of rise in defense outlays. I think in this day and age when we hope to talk seriously with the Russians and in the meantime provide an umbrella to much of the free world, it would be very foolish to gut our defense outlays back to the levels that existed a few years ago.

As you know, in the latter years of President Carter, he had proposed significant increases in defense spending, and we think that we are in the process of restoring an adequate level of defense. I am not an expert in the area, but I have talked to many experts, and I am convinced that we cannot slash defense spending in a prudent way.

Mr. PEASE. I am very happy to hear you acknowledge that real defense spending did go up during the Carter years.

Mr. SPRINKEL. The late part of the Carter years.

Mr. PEASE. President Reagan has not been so careful to make that distinction when he talks about the negative trend in defense spending during the years before he took office. Actually, he has been criticizing Nixon and Ford, but he hasn't mentioned them by name.

Mr. SPRINKEL. Well, there was a substantial decline in defense spending as a percentage of GNP throughout those years. I think it was very late in the 1970's that the pattern began to reverse a little.

Mr. PEASE. You refer to supply side economics being alive and well. Under that theory, shouldn't there have been a big increase in the personal savings rate over the last couple of years?

Mr. SPRINKEL. And there may have been. We do not have good data in my opinion. If you use the Commerce Department data, it is a residual and any mistake made in all the computations on spending and income show up in what is left, that is the personal savings rate. And there has been some improvement in that number, but it has not been massive.

On the other hand, if you approach it a different way—and I don't feel comfortable with that way either—look at the distribution of assets, holdings by individuals, there has been a massive increase. The Federal Reserve has a flow of funds in a series which cannot be made consistent with the Commerce reports which show there has been a substantial increase in liquid assets held by the American consumer, and I believe that marginal tax rates impact savings. But I certainly cannot prove it based on the evidence that we have.

Mr. PEASE. That is a little glitch in supply side economics, in other words?

Mr. SPRINKEL. I don't believe it is a glitch. I think people prefer more to less, and when you tax them less, they will save more.

Mr. PEASE. You are still expressing that as a belief, but the evidence of the last 2 years would not support that.

Mr. SPRINKEL. We do not have a good accounting system which makes it possible to be very confident of that statement.

Mr. PEASE. You mentioned that you did not want to increase taxes as a way of reducing the deficit, especially if it affected marginal tax rates.

Mr. SPRINKEL. Yes, sir.

Mr. PEASE. What would be your position on an alternative corporate minimum tax?

Mr. Sprinkel. Corporations don't pay taxes, people pay taxes. I think we are fooling ourselves when we think that we are avoiding taxing people by increasing taxes on corporations. If you decrease the incentive to invest in the process, which is what I think you would do, it is not exactly the way that I would consider moving toward higher rates of economic growth, more job creation, reduced unemployment.

So I think we must be very careful to avoid interfering with investment process and creating disincentives to invest. I would have to see the nature of the proposal, but in general, I would prefer to recognize the truth that this tax is not really a tax that would get passed onto others, and people pay taxes.

Mr. Pease. In the beginning of 1983, President Reagan did propose to the Congress a corporate minimum tax. Was that an error on his part in your view?

Mr. Sprinkel. I don't remember that proposal. I doubt it was a mistake, and certainly the President has moved very aggressively to improve capital recovery provisions, to increase the rate of return on investments in this country, and the fact that capital spending is rising very rapidly despite the uncomfortably high level of interest rates strongly suggests to me that something happened out there and the something was a higher prospective rate of return on investment. And much of it was due to the tax adjustments made earlier plus the recovery on the economy.

Mr. Pease. If I could demonstrate convincingly to you that President Reagan did, indeed, in his economic message propose a corporate minimum tax, would that change your view on the wisdom of such a tax?

Mr. Sprinkel. No, sir. My major concern is that we retain the benefits that we all worked hard to get and that we do not let short-run interests and quick-fixes create additional difficulty in achieving longer term problems.

Mr. Pease. You would say that he was in error?

Mr. Sprinkel. No, sir, I didn't say that.

Mr. Pease. Well, let me ask you if you are reasonably satisfied with a downpayment, something less than $150 billion over 3 years, toward a budget deficit that is projected to reach $700 billion. What do you think the policy ought to be next year, in 1985?

Mr. Sprinkel. The same policy as this year, continue to exert severe restraint on Government spending and let growth generate more revenues and, hence, continue to make progress in reducing the deficit. I don't think it is critical that we have a balanced budget next year. I do think it is critical that we have a pattern of declining deficits.

Mr. Pease. What sort of a downpayment would you think would be appropriate in 1985?

Mr. Sprinkel. Well, I would like to see how the economy is performing, and I would like to see what is doable in the Congress, and that means I would like to see what happens in the election. But I think that both parties recognize the seriousness of large deficits, and I am very pleased with the way they are working on it.

So I can't answer your question, but I think we should return to that challenge next year, and I hope we will.

Mr. Pease. The deficit next year is likely to be in excess of $200 billion, or somewhere along that line, which is roughly equivalent to the total nondiscretionary spending of the U.S. Government. Where would you recommend that we cut back on spending considering that the categories are nondiscretionary spending, interest payments, military spending, and entitlements such as social security?

Mr. Sprinkel. In the first place, I don't have much confidence in my projections of future deficits or in other people's projections of future deficits. I have seen them go sadly awry; $200 billion for next year sounds excessive to me. We are enjoying good economic performance in the economy which is gradually building up revenues. We are seeing some slowing in the rate of rise in Government spending, and I hope we see additional results from the actions now being taken by the administration and the Congress.

So I would be very disappointed if it is $200 billion next year. I think it would be significantly less than $200 billion.

As to where it should be cut, this decision has to be made by experts in general. The President has indicated a willingness to slow the rate of rise in defense expenditures over the earlier estimates and placed heavy emphasis on trying to cut further the rate of increase in nondefense expenditures. So we have to work on all those problems.

Mr. Pease. Isn't it true that the OMB generally has been underestimating the deficits over the last couple of years?

Mr. Sprinkel. They certainly underestimated them back a year or so ago. Who is to say they will continue to overestimate them. I don't know.

Mr. Pease. Finally, let me turn——

Chairman Gibbons. We have about 10 minutes left to vote.

Mr. Pease. I would yield then.

Mr. Jenkins. We will get an opportunity in the House to vote on the $50 billion tax increase separately from the spending cut package. This should be in the neighborhood of $100 billion over the 3 years. If you had the choice between a $100 billion reduction in spending and nothing on the revenue side, or would you prefer to have the $150 billion package which would include the $50 billion in tax increases?

Mr. Sprinkel. It seems to me that to make it politically——

Mr. Jenkins. I am just asking which is best for the Nation?

Mr. Sprinkel. I want to get it done and, hence——

Mr. Jenkins. I may get an opportunity to vote against the tax.

Mr. Sprinkel. Are you asking heart of hearts, if I had a choice of either cutting spending or having a combination of cutting spending and raising taxes, which I would prefer?

Mr. Jenkins. Yes.

Mr. Sprinkel. I would prefer cutting spending, but I don't think that is doable. I think we need both in order to get through both the Senate and the House.

Mr. Jenkins. I am not worried about politically. Do you think it would be better to cut $100 billion in spending and forget the $50 billion in the tax increase?

Mr. **Sprinkel**. You asked if I had a full choice on my part, would I prefer cutting government spending to raising taxes? The answer is yes.

Mr. **Pease**. I think Mr. Jenkins' question was quite clear. The choice we face is going to be on this year's package of $100 billion in spending cuts and $50 billion in tax increases. His question was: If you had to choose for the good of the country, would you accept the $100 billion in spending cuts and not go ahead with the $50 billion in tax increases?

Mr. **Sprinkel**. I am very happy with the package because I think it is doable, and we are certainly committed to it.

Chairman **Gibbons**. I think what the witness was saying is if it were a perfect world, he would cut expenditures without raising taxes, but in the world in which we live, he realizes the taxes have to be raised along with spending.

Mr. **Sprinkel**. Yes, sir.

Chairman **Gibbons**. With that caveat, we will close this session, and we will convene this afternoon at 2 o'clock to hear the Secretary of Commerce, Mr. Baldrige. Mr. Sprinkel, we appreciate very much your expertise and your courtesy in presenting your testimony. Thank you very much.

Mr. **Sprinkel**. My privilege. Thank you, sir.

[Whereupon, at 11:45 a.m., the subcommittee was recessed to reconvene at 2 p.m.]

AFTERNOON SESSION

Chairman **Gibbons**. Good afternoon, ladies and gentlemen. We welcome you back to the hearing dealing with our trade deficit.

As everyone knows, we started yesterday with Ambassador Brock and the Chairman of the Export-Import Bank, Mr. Draper, and this morning with Mr. Feldstein and with Mr. Sprinkel. This afternoon we have our distinguished Secretary of Commerce, Mr. Baldrige, with us.

Mr. Baldrige, we are going to turn you loose here and you can proceed as you wish. We realize you are not responsible for this deficit, so don't take on any personal burden.

I would point out, though, that the figures you see to your right there are from your Department and we have sort of mistitled that first chart on the left; that should be "the U.S. merchandise trade deficit" and the second one, of course, is the balance of payments or current account deficit.

We are really interested in three things: Where are we, how did we get here, and where are we going? And I guess the fourth thing is, what does all of this mean for the American economy?

So we will turn it over to you and let you proceed.

Secretary **Baldrige**. Thank you, Mr. Chairman.

This won't be the first time I have cleared the hall, sir, so don't be concerned about that.

Chairman **Gibbons**. Well, we have Mr. Pine here, a distinguished local newspaperman.

STATEMENT OF HON. MALCOLM BALDRIGE, SECRETARY OF COMMERCE

Secretary Baldrige. I am pleased to have this opportunity to discuss these matters with you. As you pointed out, our merchandise trade deficit was $69 billion in 1983. That is a jump of almost $27 billion over the preceding year.

There just can't be much doubt as to the three leading sources of that increase in the deficit. First is the dollar. In my view, the high value of the dollar is the most significant contributor to our current problems. Second is a divergence in business cycles throughout the world and the third is the LDC debt crisis.

The appreciation of the dollar that began in late 1980 has placed U.S. goods at a substantial price disadvantage in foreign markets and placed foreign goods at a considerable price advantage in the U.S. market.

The U.S. economy has rebounded more quickly and vigorously than those in other industrial nations, especially the European community. As a result, U.S. exports to the developed countries were practically flat in 1983. But U.S. imports, because of our growth here, expanded from all regions.

Debt problems of the less developed nations have had a dramatic effect on trade performance. In 1983 U.S. exports to developing nations dropped by $9 billion. This drop was almost entirely in manufactured goods, especially capital equipment and concentrated regionally.

Three nations alone, Mexico, Brazil, and Argentina, accounted for a loss of $4 billion in U.S. exports in 1983.

The high value of the dollar, our strong economic recovery and the LDC debt problem are the most pervasive causes of the current trade deficit. However, there are other trends visible at an industry level that are contributing to the problem.

For example, the import penetration of capital goods has steadily increased—from 6 percent in 1970 to 19 percent in 1983. Imports of high technology products have also experienced dramatic growth. For example, imports of automated data processing equipment from Japan increased by almost $1 billion in 1983, contributing to a deficit with that country of some $22.4 billion.

These trends reflect the development by foreign nations, particularly in Asia, of industries which produce sophisticated goods that are competitive with U.S. products, both in terms of technology and quality.

Low foreign wages and costs have contributed to this development, especially for the newly industrializing countries, but it is clear that our technological advantage has diminished.

I would now like to briefly discuss another key component of the current situation, which is services.

The services accounts in the U.S. balance of payments have shown a surplus for all of the last 24 years. This has helped offset the deficits in merchandise trade, which have occurred in 11 of the past 24 years.

In 1982, however, our surplus in services not only stopped growing, it declined to $33 billion. Preliminary data for 1983 show a substantial further drop to $28 billion.

This decline has resulted in part from a drop in net earnings on foreign investments. These earnings have traditionally been the largest positive item in our services trade.

However, the decline is also the result of rising U.S. imports of tradeable business services provided by foreign firms, such as insurance and other financial services, tourism and transportation.

Finally, it is the result of increasing foreign barriers, which have hurt the competitiveness of our services abroad. Just as with merchandise trade, foreign government incentives and subsidies—as well as lack of access—have had a significant impact on our services exports.

I am not optimistic about the outlook for 1984. The deficit will continue to grow, perhaps reaching $110 billion. Although the economies of our major trading partners will continue to pick up, they will not improve sufficiently to offset increased U.S. imports resulting from the continued strong growth of our economy.

There is some evidence that the dollar will continue to decline, although in the past few weeks it has shown some renewed strength. Nevertheless, even if the dollar were to fall further in the next few months, as well it might, there would be no significant effect on the trade deficit until 1985.

With respect to the LDC's with debt problems, our trade position may be better in 1984, only because the decline in our exports to these nations seems to have flattened out. We can expect little growth in exports next year and, barring some miracle, only slow growth in future years. In order for these nations to service their debts, they will have to run trade surpluses with the industrialized countries.

Since the most important factor contributing to our trade deficit is the overvalued dollar, a significant decline in the value of the dollar vis-a-vis the currencies of our trading partners would be a most positive development for our trade picture. As I mentioned, there are already signs that the dollar is declining in value to a more reasonable level.

As a result of the fact that economic growth is typically fastest in the earlier stages of recovery, I do expect that the rate of import growth will begin to slow somewhat over the next several quarters.

Likewise, as the economies of our trading partners continue to recover—at least in part as a result of the stimulus of our own recovery—the demand for U.S. exports should increase to some degree.

I am less sanguine regarding the LDC's. It will be several years, by even the most optimistic forecasts, before we will see meaningful growth in their markets. The administration has taken steps to help in the adjustment process, including the provision of $2 billion in special Eximbank credits to Brazil and Mexico to help stem the drop in U.S. exports to these nations.

Mr. Chairman, this administration is committed to reducing our trade deficit. However, the causes of the deficit are complex, and there is no simple strategy for a significant reduction.

There is no immediate solution to the problem, nor can I recommend any course of action which would have immediate effect, since in my view any such solution would be short lived and would eventually make matters worse.

There are, however, several positive steps that have been and ought to be taken. First we must do what we can to reduce our annual budget deficits to a more manageable level, so as to permit an orderly decline in the value of the dollar.

Also, we must continue vigorously to enforce our trade laws. U.S. firms must be able to compete on fair and even terms with foreign firms.

We must continue to press for the elimination of barriers to our goods and services, and for access to foreign markets where we enjoy a competitive advantage, such as those for computer equipment and software, aerospace, and communications equipment.

We must continue to promote the basic competitiveness of U.S. industry. The proposals the administration has made to encourage R&D and innovation, such as the easing of antitrust restraints on joint R&D efforts, reflect our recognition of the problem, but more must be done.

It is for this reason that the President's Commission on Industrial Competitiveness was established. The commission, which is chaired by John Young of Hewlett-Packard, is working closely with the Cabinet Council on Commerce and Trade, which I chair, and we anticipate valuable recommendations when the commission's report is issued in September.

We must continue to implement and follow economic policies that will stimulate savings and investment. The traditional U.S. comparative advantage lies in developing new products and processes, and bringing them to the marketplace before anyone else does.

To preserve this advantage, we must have a dynamic economy characterized by high rates of investment and the least possible hindrance from Government regulation.

Finally, we must organize those parts of the Federal Government responsible for trade matters in order to meet effectively and efficiently the difficult challenges of an increasingly competitive international marketplace.

The Congress ought to move forward with the President's proposal for a new Department of International Trade and Industry, which would combine responsibility for trade policy development and implementation under one roof. The establishment of a Department of International Trade and Industry will send an important signal to our trading partners that we are serious about resolving our trade problems, and that fair and free trade is among our major policy objectives.

Mr. Chairman, that concludes my statement. I will be happy to answer any questions you may have.

[The prepared statement follows:]

STATEMENT OF HON. MALCOLM BALDRIGE, SECRETARY OF COMMERCE

Mr. Chairman and members of the subcommittee, I am pleased to have this opportunity to discuss with you the U.S. trade deficit and its causes.

The 1983 merchandise trade deficit was $69 billion, an increase of nearly $27 billion over 1982. this figure represents an increase of 5.9 percent with respect to imports, and a 5.5 percent drop with respect to exports, over 1982.

There can be little doubt as to the three leading sources of the increase in the deficit in 1983: The first is the dollar. In my view the high value of the dollar is the most significant contributor to our current problems. Second is the divergence in business cycles throughout the world, and third is the LDC debt crises.

The appreciation of the dollar that began in late 1980 has placed U.S. goods at a substantial price disadvantage in foreign markets, and placed foreign goods at a considerable price advantage in the U.S. market.

The U.S. economy has rebounded more quickly and vigorously than those of other industrial nations, especially the European community. As a result, U.S. exports to the developed countries were practically flat in 1983, but U.S. imports, stimulated by strong U.S. growth, expanded from all regions.

Debt problems of the less-developed nations have had a dramatic effect on our trade performance. In 1983, U.S. exports to developing nations dropped by $9 billion. This drop was almost entirely in manufactured goods—especially capital equipment—and concentrated regionally. Three nations alone (Mexico, Brazil, and Argentina) accounted for a loss of $4 billion in U.S. exports in 1983.

The high value of the dollar, our strong economic recovery and the LDC debt problem are the most pervasive causes of the current trade deficit. However, there are other trends visible at an industry level that are contributing to the problem.

For example, the import penetration of capital goods has steadily increased—from 6 percent in 1970 to 19 percent in 1983. Imports of high-technology products have also experienced dramatic growth. For example, imports of automated data processing equipment from Japan increased by almost $1 billion in 1983, contributing to a deficit with that country of some $22.4 billion.

Mr. Chairman, these trends reflect the development by foreign nations, particularly in Asia, of industries which produce sophisticated goods that are competitive with U.S. products, both in terms of technology and quality.

Low foreign wages and costs have contributed to this development, especially for the newly industrializing countries, but it is clear that our technological advantage has diminished.

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Since the most important factor contributing to our trade deficit is the overvalued dollar, a significant decline in the value of the dollar vis-a-vis the currencies of our trading partners would be a most positive development for our trade picture. As I mentioned, there are already signs that the dollar is declining in value to a more reasonable level.

As a result of the fact that economic growth is typically fastest in the earlier stages of recovery, I do expect that the rate of import growth will begin to slow somewhat over the next several quartes. Likewise, as the economies of our trading partners continue to recover—at least in part as a result of the stimulus of our own recovery—the demand for U.S. exports should increase to some degree.

I am less sanguine regarding the LDCs. It will be several years, by even the most optimistic forecasts, before we will see meaningful growth in their markets. The administration has taken steps to help in the adjustment process, including the provision of $2 billion in special eximbank credits to Brazil and Mexico to help stem the drop in U.S. exports to these nations.

Mr. Chairman, this administration is committed to reducing our trade deficit. However, the causes of the deficit are complex, and there is no simple strategy for a significant reduction. There is no immediate solution to the problem, nor can I recommend any course of action which would have immediate effect, since in my view any solution would be short-lived and would eventually make matters worse.

There are, however, several positive steps that have been and ought to be taken. First, we must do what we can to reduce our annual budget deficits to a more manageable level, so as to permit an orderly decline in the value of the dollar. Also, we must continue vigorously to enforce our trade laws. U.S. firms must be able to compete on fair and even terms with foreign firms. We must continue to press for the elimination of barriers to our goods and services, and for access to foreign markets where we enjoy a competitive advantage, such as those for computer equipment and software, aerospace, and communications equipment.

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Mr. Chairman, that concludes my statement. I will be happy to answer any questions you may have.

Chairman GIBBONS. How much longer do you think this trade deficit is going to go on and how far will that red line go before it starts to turn around and go up?

Secretary BALDRIGE. Well, it is very difficult to try and make any kind of scientific estimate, Mr. Chairman.

Chairman GIBBONS. It was not a very scientific question, so go ahead.

Secretary BALDRIGE. It is clearly going to get worse before it gets better. We have already seen a $10 billion deficit for the month of February.

I think that that rate will begin to slow down in the latter part of the year, as economies around the world begin to recover more and as our own recovery begins to moderate some, but we will still have major trade deficits, in my opinion, for some years to come.

If we were to have, and this is, let's say, based on a computer run, Mr. Chairman, and it assumes all kinds of variables that may or may not be true, so you can't go by this exactly. But let's say we had a dollar decline of some 30 percent, spread over a 2-year period.

We could see the trade deficit brought back to zero in 3 or 4 years. But that is a highly theoretical exercise and not really a proper answer to your question.

Chairman GIBBONS. I am not so sure it wasn't a proper answer. I realize that we are all dealing with so many variables that it is hard to put your fingers on it.

You mentioned a number of things at the conclusion of your statement that you think ought to be done, and certainly we will pay serious consideration to those suggestions.

Is there anything you caution against us doing such as steel quotas and things of that sort?

Secretary BALDRIGE. The steel quota bill would clearly do a couple of things. First it would raise prices to all of the people who buy steel in the United States.

Second, it would ensure that 10 years down the road, the steel industry would be less competitive internationally than it is now.

I think those are the two main things that would happen inside the United States.

Now, outside the United States, we would be perceived as taking one of the most major steps we could possibly take toward protectionism. The question, if we took it, would be, where do we stop? Machine tools, copper, shoes, everybody could say "if steel goes that way, why not us?" Those pressures would be difficult to resist if we ever got a steel quota bill.

In the other countries around the world, I think we would see two things happen. There would be some retaliation. That is usually the point stressed. But I would like to stress another point, Mr. Chairman.

There are a good many government leaders around the world who feel as we do that free trade is vital to the growth of the whole world. If they saw the United States taking a giant step backward toward protectionism, they would feel that the leadership in this area had shifted from our shoulders. They would not have the political will to resist the protectionist measures in their own country.

In my opinion, we could be off to the races and toward worldwide protectionist growth which would clearly hurt U.S. jobs in the long run, and in the short run, I would say.

Chairman GIBBONS. Mr. Secretary, I don't know too much about the international banking field, and I obviously don't know much about our domestic banking field, but it is my observation as an outsider looking at the situation that in the adjustment that had to go on within the United States, our bankers have had to take less of the adjustment than the farms and factories of the United States.

Farms and factories have lost a considerable amount of ground. The banks have maintained theirs.

I would like your observation on that and perhaps some words of what we may do the next time we run into this problem as far as that is concerned.

Secretary BALDRIGE. Well, I have been a farmer in the sense that I owned a ranch for a good many years and I worked as a manufacturer for a good many years. And there were many times when I wished I was a banker during that period.

The banks are facing some difficult problems now in this debt with the LDC's. I don't think it is fair to lay the whole blame on the large U.S. banks for making those loans as some would. I think the whole problem of recycling the petrodollars has loomed as a tremendous problem in the last decade. A great deal has been accomplished by banks making loans to developing countries around the world.

Our banks were somewhat encouraged by our Federal policy at that time to do it and it is true, of course, that the interest rates they got were very good.

There is a day of reckoning and we are facing it now. I don't know what will come out of the negotiations that the IMF is having with Argentina now, but clearly if there is no agreement between the IMF and Argentina, the banks are going to have to be concerned about their reporting of those loans.

I think, like all lessons learned, Mr. Chairman, to say what we should do in the future in the way of any legislation, I would find it difficult to recommend anything because in effect it is like locking the barn door after the horse is stolen.

I think that normal management responsibilities of directors and so forth will mean that the banks will show a great deal of prudence in the future in any like cases.

Chairman GIBBONS. It seems to me that the International Monetary Fund has had to respond and while they have not explicitly said to the countries, "you have got to cut off buying from America, you have got to export to the United States," that is actually what has happened.

Secretary BALDRIGE. That is what has happened.

Chairman GIBBONS. And the farms and the industry of America have taken a tremendous beating from that, and the bankers continue to receive little or no, even, criticism, certainly no financial loss for some of the decisions that were made.

It just appears to me that it is a problem; that we need to share this responsibility a little better than we have. I don't want anything that I say to sound antibank, but if the banks are to have the kind of discipline that they need to make tough decisions, they are going to have to have some pain, too, along with the farmers and the manufacturers of this country.

I don't see that the pain has been equally distributed in this readjustment process and that is one of the things that worries me. And I don't think that we have moved, or even have any idea how we ought to move, to make sure that we don't repeat the same mistake that we are apparently repeating now.

Mr. SCHULZE. May I ask a question on the chairman's question?

Chairman GIBBONS. Sure. Go right ahead.

Mr. SCHULZE. Sam, what is running through my mind is the overcapacity in steel. Are you saying in effect that the banks that have been lending money to foreign nations to build more capacity for steel don't deserve an awful lot of sympathy because they are as much of the problem as they are the solution?

Chairman **Gibbons**. Well, they are going to get their money back and their interest back. There may be some delay. And they will also have their jobs in the bank secure.

In the meantime, they have been going out and expanding their banking operations rapidly, taking over things outside of banking area.

And yet at the same time, the people that work in the fields and work in the factories and the managers and owners of those farms and factories have all taken a pretty heavy punishment for what apparently was essentially a banking problem to begin with as far as foreign loans are concerned. And I believe in a responsible society, you have got to put the pain in the place it will do some good.

But we don't seem to have thought through that problem. Maybe I have not thought it through.

Mr. Secretary, you are wise to remain quiet.

Are there any other questions?

Mr. **Schulze**. Yes, thank you.

I would like to welcome the Secretary before our committee. Again, it is always a pleasure to have you here.

Mac, it seems to me when we are trying to solve a problem, the best thing to do is first see what are the major components of that problem. When I look at that I see that our most favorable figure are our agricultural sales were around $32 or $34 billion, something like that, and our largest import is in the petroleum area. It is somewhere around $60 billion.

Is that right?

Secretary **Baldrige**. Yes.

Mr. **Schulze**. Now, if we were to skew our national policies away from oil and toward natural gas, which I am told we have a fairly substantial domestic quantity that could even change that deficit figure by $10, $20, $30 billion, it seems to me that that would have to have a beneficial effect.

Every witness that has been before us has said we must do something to bring the budget deficit down to acceptable levels. It seems to me that this is the largest component in this.

I realize it is not in your realm but I would like to have your thoughts on it.

Secretary **Baldrige**. If I understood you right, your point is that if we were to skew national policy toward the use of natural gas so we would not have to import so much oil, that that would help the trade deficit.

Mr. **Schulze**. I guess I am asking you whether that would and could be one of the solutions to the deficit.

Secretary **Baldrige**. Well, you know in a lot of ways in the past we have fooled around trying to skew natural gas one way or the other, and we have always ended up in some kind of a mess.

Mr. **Schulze**. Let me interject parenthetically, I guess by skewing what I am saying is maybe that should be deregulating, at least have a level playing field.

Secretary **Baldrige**. Well, I think we should have deregulation, down the road, of natural gas and let that find its own level. That is a very controversial subject, obviously, particularly in an election year.

But long range that is clearly where we are headed and that would be the best thing for the economy and the consumers. Then cost per energy unit would find its own level.

We import, I think, some 28 percent of our oil now and there is no question that, if some time down the road natural gas is deregulated and sufficient additional supply found, that that could take over a good part of that.

I don't know what else we could do in the meantime to regulate natural gas. The fact that we deregulated oil has greatly helped us in finding more oil in the United States, and that has worked out successfully. I think that that is the way to go.

Mr. SCHULZE. The imports are still increasing a little bit, aren't they? Are they starting to go back up now, oil imports?

Secretary BALDRIGE. Yes, but I don't think that is a major trend.

Mr. SCHULZE. I guess what I am saying is, is there some way we could get out of about half our oil imports and put that into domestically produced natural gas? It should create a very beneficial effect for our economy.

Secretary BALDRIGE. Well, I would say deregulation of gas would be the best way to do that.

We have seen a major and, I think, a long-lasting drop in the use of oil per unit by almost any measure you want to use, unit of manufacture, gasoline, and so forth, in industry.

We are using 22 percent less oil per unit of manufacturing, and I think that will drop even more rather than come back the other way, because, as new plants are being built, they are made very energy efficient, designed that way and gradually, as the old, inefficient plants are phased out, we will see a continuing improvement.

Mr. SCHULZE. Let me change the subject a little bit. When I first became aware of countertrade some 5 or 6 years ago, it concerned me greatly because I thought here is a great opportunity for dumping and unloading stuff onto equipment in our markets without any kind of structured price regulation.

Everybody involved with trade said, oh, no, it is great and stupendous because it gives us overseas sales, which we would not ordinarily have.

So I have remained quiet about countertrade and just watched and it seems to me that some of my fears are coming true, that it is being used as a route for dumping.

I wonder if you would think out loud and give me your thoughts and see whether you think we ought to either monitor it or whether we should take a closer look at it, whether we should try to regulate it, whether you have given any thought to that area.

Secretary BALDRIGE. You know, Mr. Congressman, to date we have not had a countervailing duty petition charging subsidies or dumping through countertrade. And that is not to say we don't have some and maybe there are some out there that just are not recognized, but we have not, to the best of my knowledge, had one yet.

Mr. SCHULZE. I think it would be almost impossible to bring one, though. It would be very difficult.

Secretary BALDRIGE. I don't think it would be impossible. It would be very difficult. We would have to go into some new rules.

We, as a government position, try to discourage countertrade because countertrade is different from straight barter in the sense that you are forced by the host country to take a certain amount of widgets or chairs or whatever it is that they have the most of and then you try to sell them through the rest of the world to get somebody else to buy them.

Lots of times it piles cost upon cost. You have two selling costs and sometimes three and so forth. It is a last resort kind of thing. We tend to discourage it all we can.

Barter is different. Countries are going to use barter when they don't have any hard currency. We don't have a particular administration position on that but I think commonsense would say that our private firms throughout the country are rapidly, and I mean rapidly, learning how to handle barter deals.

I see new companies springing up all the time and some very large companies that are doing that around the world in the same manner that the Japanese trading companies do it. And I think that is part of the game that, whether we like it or not, is here to stay.

We should have experts in it. But I don't like to see our companies get in positions where they are forced to take a certain particular item in order to do trade in that country.

Mr. **Schulze**. I guess, Mac, if I were a foreign national, and thinking of how I could get around the dumping countervailing duty laws, I would cast a very desirous eye on barter and/or countertrade as a way to avoid that.

Secretary **Baldrige**. Well, I would hope you have not given all kinds of countries some new ideas, Mr. Congressman.

Mr. **Schulze**. I think it is going on now. There would be no way for you to know it, would there?

In other words, why would it be expanding at such a rate? Because you are not talking about prices; in effect, you are just talking about exchange of goods.

Secretary **Baldrige**. It would be difficult but we could do it, I believe. There is a going price for the kind of goods that, let's say, one of our companies would exchange or a foreign company would exchange for the item that is going to be counter-traded and there is a going price for the item to be counter-traded.

There are all kinds of selling commissions in there and I think that if somebody had run into it on any scale, they would have filed a petition with us. And we have not seen one yet. That is not to say it is not going on.

Mr. **Schulze**. I think you have put your finger on it. It is not that great a scale on any one item and it is probably very, very small.

Secretary **Baldrige**. After your astute comments, Mr. Congressman, maybe that will jump up.

Mr. **Schulze**. I would suggest perhaps we anticipate it and have people start observing counter trade as well as barters, so that we don't wake up one day and find the market flooded with it.

Secretary **Baldrige**. That is a very good point. We will look into that.

Mr. **Schulze**. Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

Chairman GIBBONS. Mr. Pease.

Mr. PEASE. Thank you very much, Mr. Chairman. I will be brief.

Mr. Secretary, I would like to commend you for your good, well-balanced testimony. I appreciate it very much.

You mentioned three leading sources of the increase in the trade deficit in 1983 and we have heard from other witnesses about the same three.

You added, to use your words, there are other trends that are contributing to the problem. You mentioned the import penetration of capital goods.

Does this suggest to you or do you mean to suggest that if the strength of the dollar were to diminish somewhat and economies of other countries were to catch up with ours so we don't have that imbalance and the LDC debt problem were somehow to go away so that the three leading sources you mentioned are no longer operative, that we would still have some troubles because somehow we are not as efficient as other countries?

Secretary BALDRIGE. Well, that is certainly true in some cases, Mr. Congressman. I don't mean that as a whole this country is deindustrializing or whatever fancy term some people use. Our rate of manufacturing has really increased as much as it had in the past.

The relative share has been proportionate in the United States as a percent of the GNP, but in some areas we have not kept competitive. We have been doing, in some areas, kind of the same old thing while the rest of the world has not only caught up but has done better than we have.

I am not just talking about wage rates here. I am talking about management efficiency. I am talking about management efficiency and quality.

We have got some problems here that we should recognize. they are management problems that occurred during the 1960's and 1970's and we have to correct them now. I think it is a difficult time we are going through now and it has certainly awakened the whole industrial segment of our economy as well as the services to the fact that they have got to be competitive to do well now at all. They simply have to be competitive.

The U.S. market is not the be-all and end-all now. International competition affects 70 percent of our business in the United States, whether those people in the United States are exporting or importing. They are affected one way or the other by 7 out of 10 items sold, and that is really making us wake up to the fact that we have to be competitive.

I don't think we are going about it fast enough yet, but I think the ship is turning around and we will get better and better at it.

Mr. PEASE. Does the Commerce Department look at specific manufacturing sectors to determine which ones are keeping up their competitive ability internationally and which ones are lagging behind?

Secretary BALDRIGE. Yes, sir; we had up until 1981, a sectoral study of about 200 industrial sectors in the United States that were set up to show what happened last year in each industrial sector. It was directed at what happened in the domestic market. It did not address the future and it did not take into account except occassionally and then not very strongly, international competition.

We have changed that now. We have set up a competitive analysis section. It takes more time and we don't have all 200 sectors but we are working to get there. Now, instead of just taking last year in the U.S. domestic market—we are taking that too, of course—we are showing what is going on around the world in world competition and projecting what is going to happen to this particular market 10, 15, 20 years from now, subject to what actions other governments are taking and the kind of global competition they are facing.

It is more of a competitive assessment industry-by-industry. You can't do that overnight. We can't do it for all 200. We perhaps have 20 or 30 of them done where we have got the process set up to where we want to get the rest of them done.

Mr. PEASE. Have you finished the study yet for basic steel?

Secretary BALDRIGE. Yes; we have done a lot of work on steel.

Mr. PEASE. Could you share with us your findings in terms of the steel industry?

Secretary BALDRIGE. Well, obviously there will be significant restructuring in the steel industry, as I have already stated. Last year there were 200 million tons—it might be a little less now—of excess steel capacity in the world. That is a tremendous overhang and had a serious effect on pricing, subsidizing, dumping, and so forth.

It meant large areas of unemployment around the world. The European community probably put $6 billion into subsidies to keep steel employment up. Of course, that was hurting our unemployment and the Europeans still have not been able to maintain their employment. That kind of action does not work.

So inevitably, with that kind of steel overhang, we will see major restructuring around the world in the steel industry. There is no way to get out of it and that means we are going to end up with a smaller but more cost-competitive and modernized steel industry in the next 10 years than we had when we began this term of office back in 1980.

The U.S. steel industry really did not keep up with the more modern plants around the world that were being built in the 1960's, the 1970's and 1980's.

We were predominant in the 1950's just after World War II. We did not go into enough continuous casting and basic oxygen furnaces, and so forth, in time and as a result we are suffering now and that has got to be restructured if we are going to be competitive.

Mr. PEASE. I think you are entirely right and the question that bothers me is how the U.S. steel industry is going to do that. The overcapacity problem is there. Some of the other countries have more efficient plants than we do.

The U.S. steel industry needs to, presumably, consolidate and certainly modernize its facilities, and yet, right now it is a low profit industry. One wonders how it is going to generate the capital needed to do the modernization, particularly when companies like United States Steel Corp. may find that they can get a larger return on their investment by buying an oil company or buying some other corporation.

I guess the reason I worry about this is that there is presumably some national security consideration to maintaining the steel industry in America.

I am just wondering whether the administration takes those things into consideration, whether it has established a minimum figure that we need to have in terms of steel production in the United States and how we are going to maintain that figure.

Secretary **Baldrige**. Well, we have not gotten anywhere near close to a minimum figure yet, Mr. Congressman, but in order for the steel industry to invest and modernize, I think that two things have to happen. One is, they have to have the ability to merge and get rid of or shut down inefficient plants.

It is sad sometimes if you are the chap working in the plant but there is no way we can subsidize an inefficient plant in this country and if we do, it just makes the whole industry less competitive. We have to have the ability to merge to put the most efficient plants of each company together with the others.

We have plant after plant in the steel industry in the United States where they were able to scrape up enough money to redo the hot end, you know, the front end and fix that up but then the finishing end, they did not get around to that. So you have an efficient front end or inefficient back end or vice versa.

We built no Greenfield plants for a long, long time. We have to have the ability to merge to get rid of inefficiencies and become efficient so that you can make enough profit to invest.

Second, when investing time comes, and the steel company has had the ability to put $3, $4 billion a year into modernization, when that time comes, we should see the industry leapfrogging the rest of the modern steel industries around the world.

It does no good at all to catch up to the Japanese and the Koreans. By the time you caught up there, by the time your investment is in place and working, they are further ahead in other areas.

We should be looking toward marrying our high technology toward our more mature industries and literally working with the goal of leapfrogging, and not just backing into that goal. That is the way this country grew and got supreme in industrial efficiency in the first place. It was not by catching up with somebody else. And I see no way out of that right now.

Mr. **Pease**. Do you think that the steel companies will come to that conclusion themselves and will implement that strategy and if not what, if anything, can the Government do to encourage them?

Secretary **Baldrige**. I think that is a very timely question. I think the steel companies in some cases have come to that conclusion. And I saw an interesting proposal from Mr. Love of National Steel, who feels that we should involve the National Laboratories, U.S. Government National Laboratories, in an effort like that. He did not mean a free ride on that where we just donate it. He meant some kind of a working relationship. We will have the Government take a very close look at that kind of a thing because that would marry up the high technology, the people with more of the basic theories with the practical people.

Mr. **Pease**. Thank you very much. I think I will assume the chairmanship temporarily here and turn the meeting over to my colleague from New Jersey.

Mr. **Guarini**. Mr. Secretary, I thank you for your very thoughtful remarks. We are in times of crisis, an ever changing world, new directions, new innovations, new ideas, and probably a very exciting time in history in the business world. You discussed barter with Mr. Schultz, using your business experience, I am wondering where you think the business world is heading. If you had a crystal ball, what would you be looking at?

Secretary **Baldrige**. I'm sorry, I missed the last part.

Mr. **Guarini**. Where is the business world going? What new inventive, creative ideas are we looking forward to? Are we going to see more joint ventures between our Nation and other nations and businesses? Is that an important direction? Are we going to see Government entities like MITI in Japan where it gets together labor and industry and participates in trying to get a triumvirate together or are we talking about other directions?

Secretary **Baldrige**. Well, that is a tremendously broad area, Mr. Congressman. I will do the best I can.

Mr. **Guarini**. I am asking you to have a crystal ball for just a few moments and share your views with us.

Secretary **Baldrige**. In the first place there are many possible oversimplifications in answering your question that people use. First, there is the oversimplification about somehow high tech is in a little niche by itself. While it is important to have technological leadership, it is only 5 to 7 percent of the work force that are involved; and even if it grew rapidly, it would be less than 10 percent, so that is not the answer. That misses the whole point.

High tech and mature industries, semimature industries must get together and they will. It is happening already, so we are seeing the average industry, not high tech, even commodity industries, agriculture, using more and more high technology. So that the high technology base in which we have the world leadership is going to spread through our industry, and what we need are managers who are swift afoot and adventuresome enough, and wise enough to make use of it as quickly as possible and do the kind of double jumping I was talking about.

Mr. **Guarini**. You think our managerial skills will probably increase and change?

Secretary **Baldrige**. I think I see them already increasing. Since what I would call the rather low point of the sixties and seventies when we were smug and self-complacent, the rest of the world was not only catching up, in some areas they were getting ahead.

Now, would you believe it, we are actually seeing the Chairmen of big companies getting fired if they don't do their jobs. That was practically unheard of back in the sixties and seventies. We are seeing companies going through all kinds of financial difficulties that have never had to face those kinds of hard times before, and it is bringing up new breeds of managers who can handle that kind of problem. You see it happening and I hope it happens quicker rather than later.

Second, I would say we should welcome high tech and welcome it into all of our industry and not just look on it as a separate thing.

Next comes the problem of whether we should try and out-MITI MITI or use the kinds of industrial policies that at times the British and the French have used in the past. I think the answer to that has been very clear, based on experience. Everybody talks about some of the successes that MITI has made. You don't hear about their failures. In the automobile world—one of the biggest successes the Japanese have had—MITI first wanted only a couple of companies. They did not want the proliferation they have now. Second, they tried to force the automobile companies not to go after the U.S. market. They thought they should go elsewhere. The automobile companies did that without MITI's guidance, and they were the ones who were proved right on that.

Mr. GUARINI. They were in the airplane business, as I understand.

Secretary BALDRIGE. Yes, sir; we have seen the British and the French get together on the Concorde. We have seen the additional calls for money for the airbus. We are seeing the French now nationalize their computer industry and say to one company, "You take main frames and another company, "You take the peripherals," and so forth. I just don't think that that is going to work. It has not worked in the past, and it is not the way that this country can work. I don't know anybody wise enough or any group of people wise enough to be able to pick the particular directions that our industry should go. Just from personal experience in running some companies and being on the boards of others, I think the average person does not realize how many mistakes are made in new products and new ideas that are failures and if you get 2 good ones out of 10, you have got to count those two good ones paying for the rest of them.

Well, if we had that kind of national policy here, where we directed any funds through some kind of an industrial bank to particular industries, we would see the industries with the most political clout get the money. Not maybe the first year, but maybe the second. That is inevitable, I think. We are much better to rely on the free market, which has the great incentive of failure as well as success. It may sound like a hard thing to say, but one of the disciplines that makes our private sector reasonably lean and forward-looking and efficient is the fact that we allow those companies to fail if they don't and new products to fail if they don't. We don't subsidize them.

Mr. GUARINI. You said that we should do more joint ventures in R&D in your statement. Do you think we should provide managerial skills in joint ventures with other countries?

Secretary BALDRIGE. Yes, sir, I am very much in favor of joint ventures in R&D because some of the projects now are so large that even large companies can't finance them and particularly because our competition outside the United States is allowed to get together and pool huge sums of money in that regard. We have got to be competitive there.

I also think in the regular merger area of just allowing companies to merge that we have to look at the fact that we are in a global market now, not just the U.S. market, and take full realization of the fact that it is a global market and what can happen to the overhang of capacity in some areas. The capacity that can be brought onstream in other areas. And, we should look at how some mergers, that might violate some of the merger guidelines now as far as concentration, would actually be procompetitive and would help us in world leadership and overall competitiveness, and would actually help the U.S. consumer as well as the worker because of the lower prices that would result.

So, I hope we are able to take a look at those two items also.

Mr. GUARINI. Do you think we are going to see more regional markets? Do you think this will be a wave in the future that we will see more countries coming together in common markets or do you think we will see less of it?

Secretary BALDRIGE. That is a very interesting question Congressman. I suppose the best answer I can give is I don't know. I think last year I probably would have answered yes, but in watching the struggles of the European market I would be more cautious now. We have seen the Latin American free trade arrangement and there is still a great deal of economic nationalism represented in every country. I think the strongest move that the world could make would be in getting together on a stronger GATT including services and strengthening the dispute-settling mechanism in GATT, which is a very weak one now, because we are going to see more and more trade problems coming as the developing countries try to work out of their problems and the developed countries try and increase their GNP.

Mr. GUARINI. Should we encourage the policies of the Eximbank which helped to subsidize our exports or would that be going in the wrong direction? Would you expand that direction or do you think it is counterproductive?

Secretary BALDRIGE. It is like if you are going to play baseball and the other fellow has a baseball bat, you had better have one, too. It would be nice if we could arrange worldwide agreement that there would be no subsidized financing for exports. We clearly can't. Therefore, we have to do it or we are going to lose business.

Now, there are a lot of advocates of free trade who would say, well, let those other countries subsidize their exports. My goodness, it helps the U.S. consumer. It is subsidized goods entering here. It is a lower price. Let the consumer enjoy it. That is a macroeconomic viewpoint that completely overlooks the fact that particular high growth, and, in many cases, high technology, industries are targeted by their governments and aided with those kinds of financing. If we don't compete with that, we will end up as a second-rate industrial power in the area of high technology. That has tremendous national security implications. It has implications for all the rest of our industry because of what we went into a little before about how high tech has to be got together with our regular industry, and those effects are ones we simply should not put up with. So I think until somebody shows me a better way we ought to try and get the terms down or eliminate it but we ought to compete with foreign countries.

Mr. GUARINI. Thank you very much, sir.

Chairman GIBBONS. Mr. Secretary, we thank you for coming today and giving us your views and the views of your department, and let me say you have handled yourself with distinction, and you showed a great deal of good common sense in addition to the distinction. It is always a pleasure to do legislative business with you.

I hope that this committee and this Congress can deal with the matter of subsidies as they impact our market in a level, even-handed way. I am a free trader, but I don't believe that free trade is subsidized trade, and I want to do all I can to stop it as it injures our market, our people. If we can get that done this year, I have got some ideas that I would like to bound off you in the future about how we can do it in third markets, how we can have some impact on that. So it is a pleasure to work with you and we appreciate your coming and helping us with that problem.

Secretary **BALDRIGE**. Thank you very much, Mr. Chairman.

Chairman **GIBBONS**. This will conclude our hearings and the committee will reconvene on April 5 at 9:30 at which time we will continue these hearings.

Thank you very much.

[Whereupon, at 3:15 p.m., the subcommittee adjourned, to reconvene at 9:30 a.m., Thursday, April 5, 1984.]

U.S. TRADE DEFICIT

THURSDAY, APRIL 5, 1984

House of Representatives,
Committee on Ways and Means,
Subcommittee on Trade,
Washington, DC.

The subcommittee met at 9:40 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Sam M. Gibbons (chairman of the subcommittee) presiding.

Chairman Gibbons. Good morning, ladies and gentlemen. As everyone knows, this is a meeting of the Trade Subcommittee of the Ways and Means Committee and we are here this morning to examine essentially the whys and wherefores and where we go on the U.S. trade deficit.

Our first group of witnesses this morning in this hearing is a panel of distinguished business executives who will discuss this issue from the business perspective. We also have two panels of leading trade economists to analyze the situation.

On the panel this morning our leadoff witness is Mr. Lee Morgan, the chairman of Caterpillar Co. and the chairman of the Business Roundtable Task Force on Trade and Investment. He is a member of the Emergency Committee for American Trade.

We also have Mr. Edwin Spencer, who is the chairman of Honeywell Corp. He is a member of the Business Roundtable Task Force on Trade and Investment and he is a member of the Emergency Committee for American Trade.

And we have Mr. Robert Kilpatrick, chairman of CIGNA Corp. He is the chairman of the Business Roundtable Budget Task Force on Trade and Investment; and Mr. John Nevin, who is the chairman of Firestone Tire & Rubber Co. and a member of the Business Roundtable Task Force on Trade and Investment.

We appreciate the great amount of expertise and experience that you gentlemen bring to this hearing. As we said, we are interested in where we are in this deficit picture, how did we get here, where do we go from here, and how do we go from here—what your predictions are. Mr. Morgan, why don't you leadoff and then introduce the rest of your panel?

STATEMENT OF LEE L. MORGAN, CHAIRMAN, CATERPILLAR TRACTOR CO.; CHAIRMAN, BUSINESS ROUNDTABLE TASK FORCE ON TRADE AND INVESTMENT; MEMBER, EMERGENCY COMMITTEE FOR AMERICAN TRADE

Mr. Morgan. Thank you, Mr. Chairman. It is nice to see you again. On behalf of my colleagues, I would like very much to thank you for the opportunity to discuss this subject that you have identified here.

In putting together this panel of witnesses we felt it would be most helpful for a diversity of business community interests to be represented. So my colleagues and I will try to bring various perspectives to your consideration of the trade deficit issue.

I will begin by offering an overview on the trade deficit and some of the implications for a traditional U.S. exporter facing severe competitive pressures around the world.

Then Bob Kilpatrick, who chairs the Business Roundtable's Budget Task Force, as you have indicated, will discuss the impact of the Federal budget and will comment on the trade concerns of the services sector.

John Nevin will then speak from the perspective of an industry severely affected by imports, stressing that there may be anticompetitive effects built into the U.S. tax system.

And our cleanup hitter is Ed Spencer, who will offer some observations on the United States-Japan bilateral economic relationship and comment on the competitive position of this country's high tech industries.

As we review the trade deficit issue, I will not promise that we will be 100 percent in accord with every issue. But I can say with complete confidence that each of us shares a deep concern about the Nation's overall economic well-being and the international competitiveness of its business sector. Further, I believe there is consensus that maintenance of a free and open international trade and investment climate is key to sustaining economic growth in the United States.

Mr. Chairman, as you know very well, last week the United States announced a $10 billion trade deficit for the month of February. The announcement confirmed the gloomy prediction that our 1984 trade performance is likely to leave us some $100 billion or more in the red.

I cannot think of any word other than "devastating" to describe the impact of that kind of trade performance on the U.S. industrial sector.

Fred Bergsten of the Institute for International Economics recently estimated that a $100 billion-plus trade deficit could shave 1 to ½ percentage points off the economic recovery in 1984. Bergsten estimates that by the end of this year some 2 million jobs will have been lost as a result of the deterioration in the trade balance.

Some economists believe the severe trade deficit will cause the economic recovery to stall. When you consider that some 80 percent of the new manufacturing jobs created in the United States from 1977 through 1980 were linked to exports, that conclusion does not seem so far-fetched.

What has happened to our trade performance? Well, generally the following are acknowledged as important factors:

One, the extraordinary strength of the dollar.

Two, the economic recovery in Europe has been so weak that it caused a $20 billion deterioration—to a $20 billion deficit—in the United States-European trade balance in the last 3 years.

And three, the virtual collapse of U.S. exports to Latin America has caused a similar $20 billion deterioration.

Obviously there is always potential for uneven economic growth in the world, but American business generally feels that if the United States would sustain a proexport set of economic policies some of the instability we are now experiencing in the trade world would be removed.

One category of U.S. Government policies that affect American trade competitiveness is the traditional list of businesses' priorities in the area of export promotion and control. I am talking about such perennial issues as export financing, tax treatment on exports, export licensing problems, and the like.

A second category getting more attention these days is the influence of exchange rates on international competitiveness. U.S. businessmen used to believe that if we made a good product and offered the customer good value for his price we could be competitive anywhere in the world. Increasingly we are finding that is not so. Exchange rate relationships are wreaking havoc on our international competitiveness.

This subcommittee, if I may respectfully suggest, should be thinking about at least two aspects of the exchange rate problem.

First is the extraordinary strength of the dollar. Since 1980 the dollar has risen in value by at least 25 percent—some figures are as high as 50—against the world's major currencies.

I believe there is virtual consensus on what needs to be done to reduce the dollar's strength. Foremost, as Bob Kilpatrick will detail, we need to make progress on the U.S. budget deficit problem. Though there may be some verbal jousting going on in Washington regarding how much the budget problem affects United States and world economic performance, I know of no businessman who does not have the U.S. budget deficit reduction near the top of his public policy priorities list.

Economists generally believe that budget deficit reduction would reduce U.S. interest rates and thus stimulate economic activity. And interest rate reduction would reduce the level of capital inflows to this country.

The present capital flows are a two-edged sword. They help the United States cover its multibillion dollar budget deficit, but they also drain needed capital from other areas of the world like Europe and Japan. Thus, they have reduced economic expansion—and demand for U.S. products—in those areas.

Budget deficit reduction, which has major implications for U.S. trade competitiveness, should be first on each of your objectives list.

The second part of the exchange rate problem relates to the Japanese yen. Though the yen may today be less undervalued than other currencies relative to the dollar, the yen/dollar relationship deserves and has recently received special attention.

Why? Because the United States and Japan are competing head-to-head, all over the world, for market share in multiple product lines.

But, frankly, I think we have too often missed the key point. And I cannot say it any better than the Washington Post did last week when it wrote that:

> This week in Washington, just about everyone was huffing and puffing at the Japanese about the beef and citrus limits. True, the Japanese ought to relax them . . .

but if the beef and citrus quotas vanished tomorrow, the additional sales would hardly make much difference in the formidable trade deficits now appearing.

"Currencies are another matter," and the Post concluded that if nothing is done to resolve the exchange rate misalignments, there is little hope for our trade picture.

President Reagan and Prime Minister Nakasone dealt head-on with the yen/dollar issue during their November meetings in Japan. Recognizing the problems the exchange rate imbalance is causing, they agreed to a set of followup discussions aimed at restoring a proper realignment.

The United States promised to do a better job on its deficit problem, and I hope the discussions presently going on in Washington will culminate in the first major step in that direction.

From the Japanese, the United States is looking for, and expects, movement on three key issues: One, yen internationalization; two, capital market liberalization; and three, financial sector access.

Progress in these areas would help move Japan more toward its appropriate role in the international economy, would have a strengthening impact on the value of the yen, and would ultimately level out the trade playing field.

But, frankly, what we have seen so far from Japan is mostly delay, and no meaningful action.

So, Mr. Chairman, I would like to use this forum today to say this to our Japanese friends: Your failure to deal appropriately with such underlying economic frictions as the role of your currency in the world economy is lessening the resolve of your supporters in the United States.

Many of us who have defended the Japanese by fighting protectionist legislation are being hurt by Japanese industrial and economic policies. Personally, I consider progress on the yen/dollar problem to be a litmus test of Japan's willingness to compete in a free and open international trading system.

Now let me move for just a moment from the macroeconomic picture to a more specific look at Caterpillar, because I think my company's recent experience is reflective of what is happening in the U.S. trade picture.

A couple of figures tell the story. In 1981, Caterpillar exported $3.5 billion of product from the United States to overseas buyers. Last year, that figure was $1.6 billion. And when we relate that decline to jobs the figures are 31,000 jobs in 1981 dependent upon exports and 16,000 in 1983.

In our company alone, reduced exports have cost 15,000 jobs in 2 years. Now we generally believe that each Caterpillar job creates two in supporting businesses, so the loss of our company's exports has cost the U.S. economy in the neighborhood of 45,000 jobs in the last 2 years.

Some of that loss is due to the international economic slump. Some of it is related to cost and price reductions that we feel responsible for making at Caterpillar, and some of it is due to United States and other government policies that have affected our exporting capability.

As the United States looks at how to deal with the problem, I urge you to take a positive approach.

Let's work on reducing barriers to exports and on eliminating export financing as a problem. Let's insure a positive U.S. business climate that fosters research and productivity and maintains restraint on the cost of the factors of production. And let's make a top priority of the exchange rate problem that American exporters face.

But let's not make further protectionist policy moves. The United States—including its consumers, its companies, and their employees who depend on international business—cannot afford them.

At Caterpillar, I would like to believe, we are widely acknowledged to have the world's most modern factories within our industry, the broadest, highest quality product line in our industry, the most effective distribution organization. Yet we are having to use every ounce of imagination and energy that we can garner to try to reduce our costs to make us more competitive. We have laid off workers. We have cut dividends. We have closed plants. We reduced salaries, and we have had no choice but to go offshore to find lower cost of manufacturing in order that we might compete.

In spite of these drastic actions, we are not helped by protectionism. For example, if the auto sector quotas presently in place result in a lack of wage restraint by the United Auto Workers, the resulting pressures on Caterpillar could ultimately add to our already critical cost problem.

If the United States imposes steel quotas, we will lose some of the savings we have realized by shopping worldwide.

And, more generally, the imposition of an import surcharge, as has been suggested by some, would cause a major disruption in the free and open trading system that we have all benefited from.

So I urge you not to prescribe protectionism as the Band-Aid for this wound.

Rather than offering protectionism, the United States needs to heighten the attention it pays to its policy mix, with special reference to the implications for U.S. competitiveness in the world marketplace.

I hope that the comments of my colleagues and I will be helpful in these deliberations.

And now, if I may, I would like to introduce Bob Kilpatrick, chairman and CEO of CIGNA and chairman of the BRT Business Task Force.

Chairman Gibbons. Thank you. But before you proceed, Mr. Kilpatrick, let me say that I have heard some eloquent and some clear and some fine statements made about the problems of protectionism, but I have never heard it stated any better from the lips of a person who understands what it does.

We look at those automobile quotas and everybody thinks well, they are a Band-Aid, they are not really hurting anyone. You have said as clearly as I have ever heard it said that it has side effects that you just cannot anticipate when you first think about these matters. Your statement is very eloquent and very inspiring and I think excellent.

Now, Mr. Kilpatrick.

STATEMENT OF ROBERT D. KILPATRICK, PRESIDENT AND CHIEF EXECUTIVE OFFICER, CIGNA CORP.; CHAIRMAN, BUSINESS ROUNDTABLE BUDGET TASK FORCE

Mr. KILPATRICK. Thank you, Mr. Chairman. Thank you, Lee. That was a very fine statement.

Good morning, Mr. Chairman and distinguished members of the subcommittee. For the record let me identify myself as Robert D. Kilpatrick. I am chairman of the Business Roundtable's Committee on the Federal Budget. I am also president and chief executive officer of CIGNA Corp.

Our company is extensively involved in international commerce and insuring companies like these that participate in commerce. We have been at this since 1792, as the oldest stockholder-owned company in the country. We are in the No. 1, 2, or 3 position as the largest of the international insurers.

As chairman of the Roundtable's Budget Task Force, I have been asked to participate in this panel today from the viewpoint of the effects that domestic budget issues have on international trade.

Concerns about the Federal budget and specifically about the Federal budget deficit have been a major priority for the roundtable for the last few years, and as a matter of fact a major priority and individual concern to all of the business people that I know.

Presently our economy seems to be in good shape. We have recovered from a serious recession and are maintaining economic momentum. Inflation remains under control, unemployment has dropped more rapidly than at any other time within the last 30 years, and consumer confidence is being restored.

Still, high Federal budget deficits remain and they are very, very troubling. They pose a basic political problem for all Americans and have resisted resolution by the Congress, the executive branch, and by both political parties. Persistent deficits in the domestic economy restrict our ability to count on a strong noninflationary recovery.

Perhaps of equal importance, continuing Federal deficits have denied in most cases hope of economic recovery in the near term to our export industries and those which must compete most directly with goods imported from abroad.

Many distinguished witnesses from Government have appeared recently, Mr. Chairman, before this and other congressional committees to testify on the many causes of and potential solutions to the international trade deficit. The most persistent and consistent message which we have heard from witness after witness has been that the Federal budget deficit must be reduced if we are to make progress in turning around the interational trade deficit.

I want to briefly repeat that message today from the viewpoint of a businessman involved in international trade. The deficits that are projected must be reduced. The most serious economic threat facing the United States today, is the Federal budget deficit.

Persistent high deficits threaten to stimulate inflation, keep interest rates much higher than they would be otherwise, and cause the dollar to be overvalued relative to other currencies. Deficits also absorb savings. The Congressional Budget Office in its reestimate of the President's budget implies that deficits would be 79 percent of net private saving in the 1984–85 period.

As a result, financing of the Federal deficit will, over time, certainly crowd out capital that should be going to increase production, improve productivity, and add jobs for American workers.

Now on the domestic side we have managed for the time being to insulate ourselves from the effects of this potential crowding out. Very large capital inflows from abroad have so far limited the rise in interest rates. But this benefit is not without its price. One negative of the capital inflow from foreign countries is the dependence it is producing in this country.

The Congressional Budget Office Director, Rudolph Penner, has stated that the income of foreign investors resulting from their ownership of American productive capacity could rise to such a level as to reduce our own standard of living below what it would be with less Government borrowing and less foreign capital.

He believes that we are also vulnerable to a change in the psychology of foreign investors. If capital inflows from foreign sources should dry up before the deficit situation improves, we would experience an increase in interest rates in the United States and much upward pressure on our inflation rate.

Federal Reserve Chairman Paul Volcker recently summed up how I think many people, or even most people in the business community, feel. He said:

> We simply cannot afford to become addicted to drawing on increased amounts of foreign savings to finance our internal economy. It is nonetheless ominous that the recorded net investment position of the United States overseas, built up gradually over the entire postwar period, will in the space of only 3 years, 1983, 1984, and 1985, be reversed.

Another way of saying this is that by 1985 the United States could become a net debtor nation.

Looking at the international side of the problem, the economic recovery is certainly not enjoyed by some of our industries. As a businessman, I look at the international trade deficit in what I think is a straightforward manner. The President's Council of Economic Advisors recently estimated that the dollar is now overvalued by about one-third relative to foreign currencies. While there are daily and weekly adjustments in currency values, this fundamental imbalance between the dollar and other currencies represents an enormous tax on American businesses competing abroad.

Similarly, the overvalued dollar makes imported goods cheaper relative to those produced at home, with the result that major segments of American industry continue to languish in recession or almost depression. As a result, jobs and long-term economic growth are being lost to foreign manufacturers and funds are not available for capital expansion at home.

The other panelists today all represent the manufacturing sector of our economy. The service sector is affected in many of the same ways as manufacturers. U.S. products, whether goods or services, become more expensive and less competitive when the dollar appreciates, with the result that exports dwindle relative to imports.

The service sector, particularly the financial service sector that I represent, also faces a slightly different situation. To a large extent, international financial transactions are facilitated by stability and predictability. High U.S. interest rates caused by persistent budget deficits and a perceived overvaluation of the dollar, to the degree presently being experienced, tend to introduce elements of instability into a rather fragile international financial situation.

The Business Roundtable position on the Federal budget, Mr. Chairman, has been to call attention to the root cause of the deficit, which we believe is excessive Federal Government spending. We urge restraint in spending across the board but especially slower growth in nonmeans tested entitlement programs.

We have also advocated that increases in defense spending—which we support—should be set at sustainable levels. As part of our position, the Business Roundtable previously has called in other testimony for a decisive downward path in the deficit to the lower of either 2 percent of gross national product or $75 billion by 1988, a difficult but a goal which is achievable with a great deal of political courage and will.

The Roundtable has also stated publicly that when possible spending reductions have been fully explored, and action programs have been defined, it is likely that new long-term revenue sources will be needed in the fiscal years beginning in 1986 if we are to reduce deficits to no more than 2 percent of gross national product.

I repeat that, Mr. Chairman, because the Roundtable has not been necessarily against revenue increases. We have been against them until certain things are done on the spending side. Efforts must reflect the national need for job creation and improved industrial competitiveness both at home and abroad, and must emphasize modernization and growth.

In conclusion then, Mr. Chairman, all of American business deserves to share in the economic recovery. I realize that no solution is achieved without paying some price, either now or in the future. Our plans should address the Federal budget deficit directly. They should also reflect the desirability of the economic situation in which all American firms have a reasonable opportunity to achieve their business objectives.

We must not penalize that segment of American industry which does business abroad simply because we cannot resolve a domestic economic situation which is mortgaging our future economic security.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF ROBERT D. KILPATRICK, PRESIDENT AND CHIEF EXECUTIVE OFFICER, CIGNA CORP., ON BEHALF OF THE BUSINESS ROUNDTABLE

Concerns about the Federal budget have been a major priority for the Business Roundtable for the last few years and a matter of individual concern to a growing number of businessmen. As Chairman of the Roundtable's Budget Task Force, I have been asked to participate in this panel from the viewpoint of the effects domestic budget issues have on international trade.

Our economy is basically in good shape: We have recovered from a serious recession and are maintaining economic momentum. Inflation remains under control, unemployment has dropped more rapidly than at any other time within the last 30 years and consumer confidence is being restored.

Still, high federal deficits remain and they are troubling. They pose a basic political problem for all Americans and have resisted resolution by the Congress, the Executive Branch and by both political parties. Persistent deficits in the domestic economy restrict our ability to count on a strong non-inflationary recovery. As importantly, continuing Federal deficits have denied in most cases hope of economic recovery in the near term to our export industries and those which must compete most directly with goods imported from abroad.

IMPLICATIONS OF DEFICITS

The deficits that are projected must be reduced. Persistent high deficits threaten to stimulate inflation, keep interest rates higher than they would be otherwise, and cause the dollar to be overvalued relative to other currencies. Deficits also absorb savings. The Congressional Budget Office in its reestimate of the President's budget implies that deficits could be 79% of net private saving in the 1984-85 period. As a result, financing of the Federal deficit will crowd out capital that should be going to increase production, improve productivity and add jobs for American workers. On the domestic side we have managed for the time being to insulate ourselves from the effects of this potential crowding out. Very large capital inflows from abroad have so far limited the rise in interest rates. But this benefit is not without its price. One negative of this capital inflow is the dependence it is producing.

CBO Director Rudolph Penner has stated that the income of foreign investors resulting from their ownership of American productive capacity could rise to such a level as to reduce our standard of living below what it would be with less government borrowing and less foreign capital. He believes that we are also vulnerable to a change in the psychology of foreign investors. If capital inflows dry up before the deficit situation improves, we would experience an increase in interest rates in the United States and upward pressure on our inflation rate.

Federal Reserve Chairman Paul Volcker recently summed up how we feel: "We simply cannot afford to become addicted to drawing on increased amounts of foreign savings to finance our internal economy. . . . It is nonetheless ominous that the recorded net investment position of the U.S. overseas, built up gradually over the entire post-war period, will in the space of only three years, 1983, 1984, and 1985, be reversed." Another way of saying this is that by 1985 the United States could become a net debtor nation.

INTERNATIONAL TRADE DEFICIT

Looking at the international side of the problem, the economic recovery is not enjoyed by all of our industries. As a businessman I look at the international trade deficit in a very straightforward manner. The President's Council of Economic Advisors recently estimated that the dollar is now overvalued by 33% relative to foreign currencies. While there are daily and weekly adjustments in currency values, this fundamental imbalance between the dollar and other currencies represents a huge tax on American businesses competing abroad. Similarly, the overvalued dollar makes imported goods cheaper relative to those produced at home, with the result that major segments of American industry continue to languish in recession. As a result, jobs and long term economic growth are being lost to foreign manufacturers and funds are not available for capital expansion at home.

The other panelists today all represent the manufacturing sector of our economy. The service sector is affected in many of the same ways as manufacturers. U.S. products, whether goods or services, become more expensive and less competitive when the dollar appreciates, with the result that exports dwindle relative to imports.

The service sector, particularly financial services, faces a somewhat different situation. To a large extent, international financial transactions are facilitated by stability and predictability. High U.S. interest rates caused by persistent deficits and a perceived overvaluation of the dollar to the degree presently being experienced tend to introduce elements of instability into the international financial situation.

BUSINESS ROUNDTABLE POSITION

The Business Roundtable position on the federal budget has been to call attention to the root cause of the deficit: excessive government spending. We urge restraint in spending across the board, but especially slower growth in non-means tested entitlement programs. We have also advocated that increases in defense spending—which we support—be set at sustainable levels. As part of our position, the Business Roundtable previously has called for a decisive downward path in the deficit to the lower of either 2 percent of GNP or $75 billion by 1988, a difficult but achievable goal.

When possible spending reductions have been fully explored and action programs have been defined, it is likely that new long-term revenue sources will be needed in the fiscal years 1986-88 time frame if we are to reduce deficits to no more than 2 percent of GNP. Efforts must reflect the national need for job creation and improved industrial competitiveness both at home and abroad, and must emphasize modernization and growth.

CONCLUSION

All of American business deserves to share in the economic recovery. But I realize that no solution is achieved without paying some price either now or in the future. Our plans should address the federal budget deficit directly. They should also reflect the desirability of an economic situation in which all American firms have a reasonable opportunity to achieve their business objectives. We must not penalize that segment of industry which does business abroad simply because we cannot resolve a domestic economic situation which is mortgaging our future economic security.

Chairman GIBBONS. Thank you, sir.

Mr. Spencer.

STATEMENT OF JOHN J. NEVIN, CHAIRMAN OF THE BOARD, FIRESTONE TIRE & RUBBER CO., MEMBER, BUSINESS ROUNDTABLE TASK FORCE ON TRADE AND INVESTMENT

Mr. NEVIN. Good morning, Mr. Chairman. My name is John Nevin. For the record, I am chairman of the board of Firestone Rubber Co.

I would ask, Mr. Chairman, if I may, that I limit my oral testimony to the material beginning on page 8 and submit the remainder for the record, the first seven pages.

Chairman GIBBONS. We will make it all a part of the record as you wish.

Mr. NEVIN. Thank you, sir.

Beginning on page 8: The imbalance in the yen-dollar relationship is widely recognized as a major cause of growing U.S. trade deficits. Some observers contend, however, that the imbalance is more attributable to adverse reactions to U.S. budget deficits than to actions the Government of Japan has taken to limit foreign access to Japanese money markets and control the use of the yen in world money markets. It is not uncommon, in fact, to hear the suggestion that if U.S. budget deficits were reduced, the yen-dollar imbalance would be eliminated, and U.S. trade deficits would decline.

Such contentions in my view are seriously oversimplified, and I would like to inject here that there is no difference between me and my colleagues as to the importance of U.S. budget deficits, and my point here is only that the trade deficits are contributing to the budget deficits as well as vice versa.

There is considerable evidence, in my judgment, to support the assertion that losses in U.S. tax revenues and increases in domestic social costs, attributable to the huge U.S. trade deficits are adversely impacting U.S. budget deficits, to at least as great an extent as U.S. budget deficits are contributing to U.S. trade deficits.

In the United States, Federal, State, and local taxes exceed 30 percent of gross national product. In Japan such taxes amount to less than 25 percent of gross national product. Japanese tax levels are lower primarily because defense expenditures total about 7 percent of gross national product in the United States compared with less than 1 percent in Japan.

Income, social security, and profit taxes that are embedded in the cost of a product when it goes to market and that are classified as direct taxes by international trade conventions amount to 25.1 percent of gross national product in the United States and 20.6 percent of gross national product in Japan.

In Japan, taxes are used to a far greater extent than they are in the United States to finance health care costs. If direct taxes in Japan were adjusted to U.S. levels of public health care funding, they would amount to only 19.3 percent of gross national product.

A $100 billion merchandise trade deficit in 1984 will result in a loss of approximately $25 billion in Federal, State, and local revenues from income, social security, or other direct taxes. A 1982 ITA study concludes that with a $1 billion of trade deficit, 25,000 jobs are eliminated in the United States. Based on that estimate, a $100 billion trade deficit would result in the loss of 2.5 million jobs and an increase in unemployment, welfare, and other social costs approximating $10 billion.

And again, if I might inject, the only Government-sponsored study of the impact of the trade deficit on U.S. tax revenues that I have seen is one that was developed by the Library of Congress in response to a request from Senator John Heinz, which had to do with the impact of the made in America proposal.

The Library of Congress in its response to Senator Heinz estimated that the impact was $550 for every $1,000 of loss, and the reason they came up with the $550 number as opposed to the 25-percent number that I am using is that they assumed that there would be a multiplier effect, in the sense that the job—the person who had the job would have spent money in local drugstores and gas stations, and there would have been other tax revenue losses.

Now, continuing with my testimony: The losses in tax revenues and increases in social costs associated with an increase in the U.S. merchandise trade deficit from $40 billion annually in the 1977–82 period to $100 billion in 1984 can be expected to have an adverse impact on the U.S. budget deficit of approximately $20 billion. A $20 billion deterioration in the budget deficit attributable to this country's worsening position in international trade would offset most or all of the fiscal benefits the Congress has sought to accomplish through curtailments in nondefense spending.

As U.S. trade deficits have grown, it has frequently been asserted that the competitive position of U.S. products has been adversely affected by excessive U.S. wage rates. The proponents of that view rarely note that wages and salaries in the United States are taxed at rates about twice those assessed in Japan. Labor in the United States must earn significantly more than Japanese labor if it is to have comparable after-tax earnings.

U.S. labor and the products it produces are today carrying a significantly larger share of the cost of defending Japan's home islands and critical supply lanes than are Japanese labor and the products it produces. That situation is worsening. The increase in the U.S. defense expenditures in 1984 over 1983 will exceed Japan's total defense budget.

Differences in total tax-levels and in the manner in which taxes are assessed have a very substantial impact on the tax-related costs that must be recovered when automobiles produced in the United

States and Japan are brought to market. A U.S.-built small car would carry with it to market about $1,550 of tax-related costs if it was sold in the United States.

Property and corporate income taxes paid by U.S. manufacturers account for about $440 of that tax burden. The remaining $1,110 is attributable to employee-related tax costs, such as the social security and unemployment taxes that U.S. employers pay on behalf of their employees and the portion of their wages that automobile workers pay to Federal, State, and local governments in the form of income and social security taxes.

A comparable car would carry a tax load of only $1,245 if it were built and sold in Japan. The Japanese manufacturers incur most of their tax costs in the form of taxes on profits and an excise tax, which is called the commodity tax, that they are required to collect at the time of sale in Japan.

International trade rules permit nations to rebate indirect taxes, but not direct taxes, at the time a product is exported, and to assess indirect taxes, but not direct taxes, on products that are imported. As a result of these conventions, a Japanese-built car that would carry taxes totaling $1,245 if it were sold in Japan would incur a tax burden of only $920 if it were sold in the United States. The car would qualify for a $575 rebate of Japan's indirect commodity tax when it was exported, and because the United States tax system relies on direct taxes it would incur only about $250 in tariffs and duties when it entered the United States.

If the same car were exported to Western Europe, it would incur a Common Market tariff and be assessed European value-added taxes, which are classified as indirect. In Europe, that car would incur a tax-related cost totaling $1,590 if it were sold in West Germany, $1,735 in Great Britain, and $2,425 in France.

The United States is the only industrialized nation that does not assess substantial taxes on imported automobiles. A $5,900 small car produced and sold in the United States incurs tax-related costs totaling $1,550 in the U.S. market. The U.S.-built car is at a tax disadvantage totaling $630 per unit relative to a Japanese import that incurs Japanese and American tax-related costs combined totaling only $920.

If the same U.S.-built car were exported to Japan, it would incur tax-related costs totaling $3,200 and be at a disadvantage of $1,955 per unit relative to a small car produced and sold in Japan.

I would respectfully suggest, sir, that an automobile manufacturer cannot incur excessive material, labor, or overhead costs and compete effectively with a more efficient producer that prices its product aggressively. Now, I would suggest that exactly the same condition exists with respect to tax-related costs.

Now let me comment a moment on the U.S. consumer. As individuals, U.S. consumers may benefit from the tax advantages that imported cars enjoy. Obviously, if a single consumer buys an imported car he may get it at a price that represents some portion of the tax savings.

As a group, however, U.S. consumers lose. U.S. Federal, State, and local governments collect taxes totaling $1,550 when a U.S.-built small car is sold domestically. They collect only $250, or $1,300 less, on the sale of an imported car. If Government services are to be maintained, the tax losses, and the added unemployment, and welfare costs associated with import-car sales will have to be recovered from other taxes, and it is U.S. consumers as a group who will pay those other taxes.

I think that concludes the material I wish to present orally, sir.

[The prepared statement follows:]

STATEMENT OF JOHN J. NEVIN, CHAIRMAN OF THE BOARD, FIRESTONE TIRE & RUBBER CO.

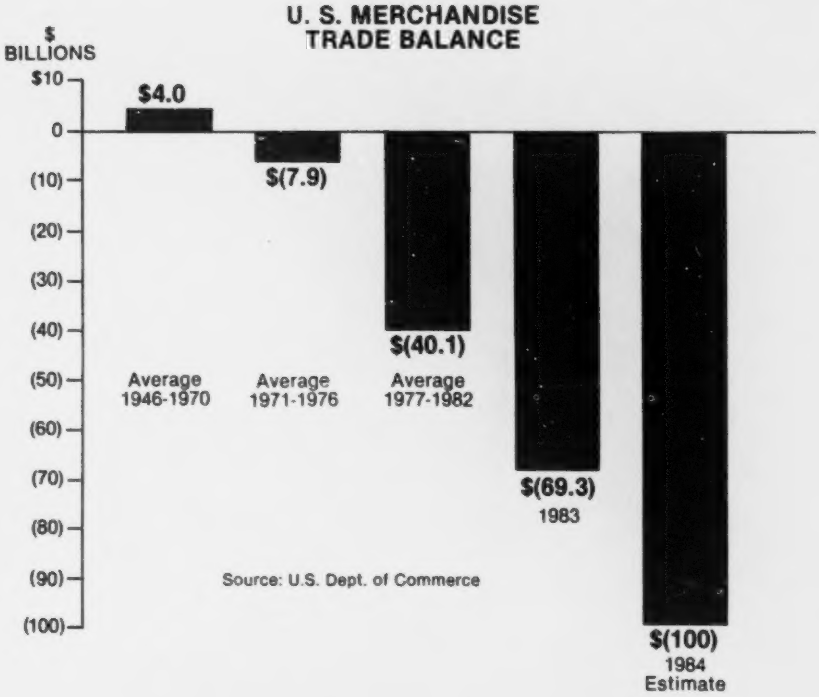
INTRODUCTION

Mr. Chairman: My name is John J. Nevin; I am Chairman of the Board of The Firestone Tire & Rubber Company.

The Subcommittee on Trade has announced that in these hearings it wishes to "focus on the underlying causes" of the growing U.S. trade deficit, "assess the implications of this imbalance for U.S. trade and economic policy," and "address what measures may be necessary to reduce the deficit."

I am very pleased to have this opportunity to express my views on these very important matters.

The Subcommittee recognized that dumping, export subsidies and other unfair trade practices have been major causes of the growing U.S. trade deficits when it approved H.R. 4784 on February 9, 1984. I do not, therefore, propose to comment on those matters in my testimony today.



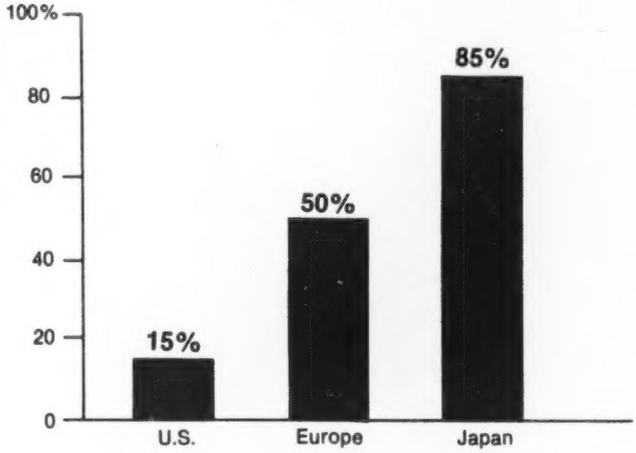
U. S. MERCHANDISE TRADE BALANCE

Source: U.S. Dept. of Commerce

Deficits in foreign trade are a recent phenomenon in American history. During the twenty-five years from 1946 through 1970, there was no year in which the United States reported a merchandise trade deficit.

During the six-year 1977-82 period, U.S. trade deficits averaged $40.1 billion annually. In 1984, the U.S. merchandise trade deficit is expected to exceed $100 billion.

ENERGY IMPORTS
AS A PERCENT OF TOTAL REQUIREMENTS
1974-1980



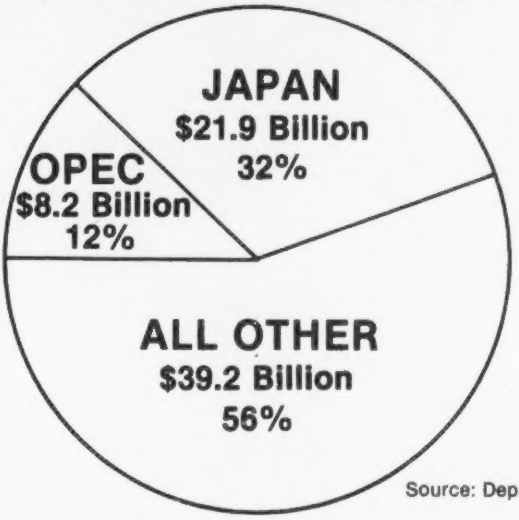
Source: Organization for Economic
Cooperation and Development

In the mid-1970s, when the U.S. first began to report huge trade deficits, many Americans were led to believe that those deficits were caused by growing imports of expensive foreign oil and that the remedy was to be found in fuel conservation.

During the 1974-80 period, however, in which the price of Saudi crude increased from $2 to $34 per barrel, it was the United States, the industrialized nation least dependent upon imported energy, that was the only industrialized nation in the world to incur huge and growing trade deficits.

COMPOSITION OF 1983 U. S. TRADE DEFICIT

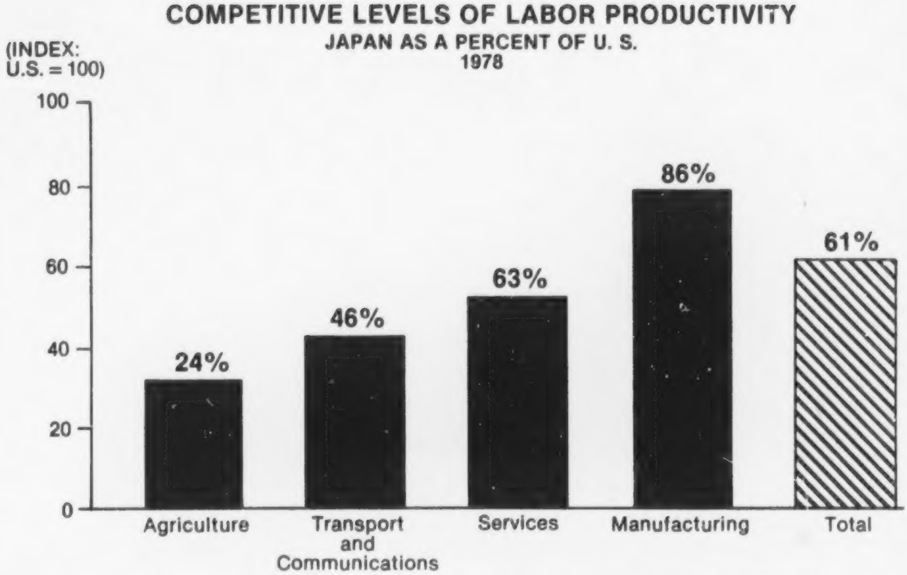
(TOTAL OF $69.3 BILLION)



Source: Department of Commerce

It is apparent today that U.S. trade deficits cannot be validly attributed to the actions of an oil cartel. In 1983, the $21.9 billion deficit the United States incurred in trade with Japan accounted for almost one-third of this country's total deficit and was more than twice as large as the $8.2 billion deficit the United States incurred in trade with the 13 OPEC nations combined.

I would suggest that there are five "underlying causes" for the growing U.S. trade deficits upon which this Subcommittee might wish to focus. Two of the five causes—U.S. productivity and the quality of U.S. products—are problems that must be addressed by the private sector. Three of the five causes—the exclusion of U.S. products from overseas markets, the overvalued U.S. dollar, and tax inequities that U.S. products confront in international trade—are problems that must be addressed by the Government of the United States.



COMPETITIVE LEVELS OF LABOR PRODUCTIVITY
JAPAN AS A PERCENT OF U. S.
1978

Source: Japan 1983, An International Comparison
Japan Institute for Social and Economic Affairs

"Japan 1983," a report published by the Japan Institute for Social and Economic Affairs, includes a number of detailed comparisons of productivity developed by the Japan Productivity Center.

The comparisons show that in 1978 Japanese labor was less than 25 percent as productive as U.S. labor in agriculture, less than half as productive in transport and communications, and less than two-thirds as productive in the service industries. In manufacturing, as a whole, Japanese productivity was found to be only 86 percent of the U.S. level.

The notion that American labor is less productive than labor forces in Japan or elsewhere in the world lacks factual support.

U. S. LEVELS OF MANUFACTURING SECTOR LABOR PRODUCTIVITY COMPARED WITH JAPAN

	JAPAN PERCENT OF U. S. IN 1980
Chemical Industry	89
Instruments	86
General Machinery	78
Textiles	74
Leather and Products	50
Pulp and Paper Products	48
Printing and Publishing	46
Foods	44
Apparels	39

Source: Japan 1983, An International Comparison
Japan Institute for Social and Economic Affairs

By "targeting" its financial and technical resources, Japan has achieved extraordinary levels of productivity in such export-oriented industries as automobiles, steel, and consumer electronics. Japanese productivity, however, is below U.S. levels for manufacturing as a whole and far below U.S. levels in many industries.

Reducing U.S. trade deficits will require that, in those U.S. industries that are being outperformed by overseas competitors, American management and labor accept the responsibility for attaining international levels of productivity. Reducing those deficits will also require, however, that the Government of the United States undertake to make certain that U.S. products, with competitive advantages, are not excluded from foreign markets by nations whose most competitive industries are granted easy access to the U.S. market.

CONSUMER ATTITUDES TOWARD MAJOR TELEVISION BRANDS

	Brand Having Highest Quality	Brand Requiring Fewest Repairs	Brand Preferred If Buying New TV Today
Zenith	32%	32%	33%
RCA	22	19	20
Magnavox	6	5	6
Sony	6	4	6
Motorola/Quasar	5	4	5
Sylvania	4	3	4
GE	3	3	3

Source: Louis Harris and Associates, Inc. (August 1978)

Several years ago, during the television importation controversy, it was not uncommon to hear or read assertions that American consumers were attracted by the higher quality of Japanese offerings rather than by their lower prices. Surveys conducted by Louis Harris & Associates, Inc. and the Gallup Organization, Inc. during the mid-1970s demonstrated, however, that American consumers had a higher regard for the quality of receivers produced in the United States than they had for the quality of imported receivers.

For some Americans, it has become fashionable to disparage the quality of products produced in the United States. The people of Europe and Asia don't share this view of American workmanship. They fly vast distances in commercial aircraft built in the United States, they manage their industry and their finances with computers built in the United States, and they rely heavily on American workers for the sophisticated military hardware that they need to defend their countries.

CONSUMERS UNION
COMPARATIVE RATINGS OF MAJOR TELEVISION BRANDS
(TESTS CONDUCTED FROM JAN. 1969 TO SEPT. 1978)*

Individual Brands	Number of Sets Tested	Best Possible Rating Number	Best Possible Rating Percent	Average Rating Or Better Number	Average Rating Or Better Percent
Zenith	21	9	43%	18	86%
Sylvania	18	4	22	13	72
Sony	9	2	22	5	56
RCA	25	5	20	16	64
GE	21	4	19	10	48
Memo:					
All U.S. Brands	186	28	15%	98	53%
All Japanese Brands	59	7	12	32	54

*Excludes one test of 15 models in which all 15 were deemed about equal in overall quality.

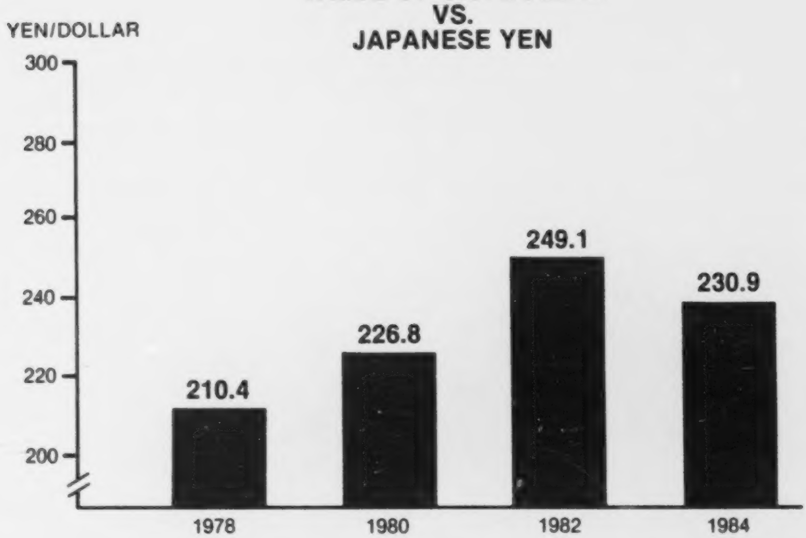
Source: Consumer Reports (various issues)

The results of comparative tests conducted by Consumers Union during the 1970s demonstrated that the American consumers confidence in the quality of domestic television receivers was fully justified. The situation has been somewhat different in the U.S. automobile market, however.

Japanese automobiles today enjoy an earned and enviable reputation for excellence in finish, fit, and reliability. Cars built in the United States have had a record of failing to meet consumer expectations in these very visible aspects of quality, although they have matched or exceeded imports in the less visible areas of durability and safety.

Reducing U.S. trade deficits will certainly require that U.S. management and labor achieve levels of product quality that meet international standards. It will also require, however, that the Government of the United States take effective action to prevent Japan and other nations from using the facade of local quality standards to impose design and testing requirements on fully competitive U.S.-produced products that are so onerous as to effectively preclude the sale of those products in many overseas markets.

VALUE OF U.S. DOLLAR VS. JAPANESE YEN



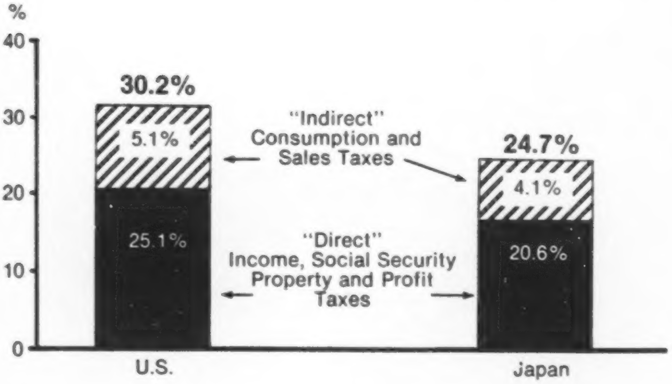
Source: Chemical Bank

The imbalance in the yen-dollar relationship is widely recognized as a major cause of growing U.S. trade deficits. Some observers contend, however, that the imbalance is more attributable to adverse reactions to U.S. budget deficits than to actions the Government of Japan has taken to limit foreign access to Japanese money markets and control the use of the yen in world money markets. It is not uncommon, in fact, to hear or read suggestions that if U.S. budget deficits were reduced, the yen/dollar imbalance would be alleviated and U.S. trade deficits would decline.

Such contentions, in my view, are seriously oversimplified. There is considerable evidence, in fact, to support the assertion that losses in U.S. tax revenues and increases in domestic social costs attributable to the huge U.S. trade deficits are adversely impacting U.S. budget deficits to at least as great an extent as U.S. budget deficits are contributing to U.S. trade deficits.

TAX REVENUES AS A PERCENT OF GROSS DOMESTIC PRODUCT

1978-1980

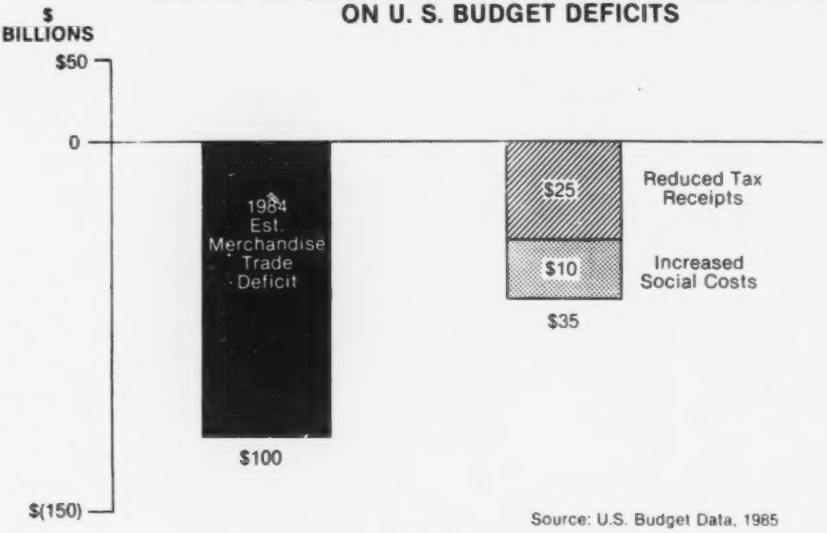


Source: Revenue Statistics of OECD Member Countries

In the United States, federal, state, and local taxes exceed 30 percent of GNP; in Japan such taxes amount to less than 25 percent of GNP. Japanese tax levels are lower primarily because defense expenditures total about 7 percent of GNP in the United States compared with less than 1 percent of GNP in Japan.

Income, social security and profit taxes that are imbedded in the cost of a product when it goes to market and that are classified as "direct" taxes by international trade conventions amount to 25.1 percent of GNP in the U.S. and 20.6 percent of GNP in Japan. In Japan taxes are used to a far greater extent than they are in the United States to finance health care costs. If "direct" taxes in Japan were adjusted to U.S. levels of public health care funding, they would amount to only 19.3 percent of GNP.

IMPACT OF $100 BILLION MERCHANDISE TRADE DEFICIT ON U. S. BUDGET DEFICITS



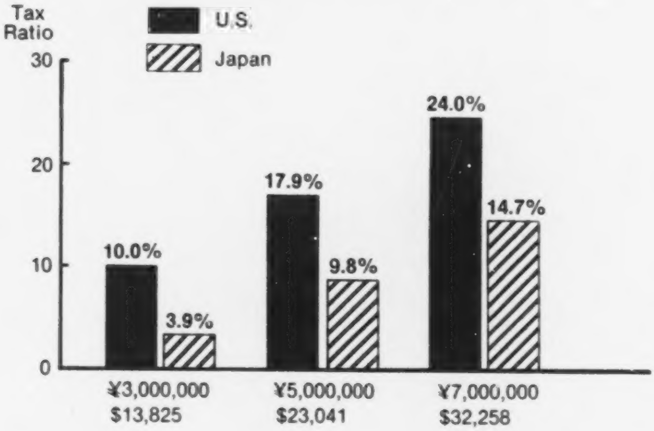
Source: U.S. Budget Data, 1985

A $100 billion merchandise trade deficit in 1984 will result in a loss of approximately $25 billion in federal, state, and local revenues from income, social security or other "direct" taxes. A 1982 ITA study concludes that for each $1 billion of trade deficit 25,000 jobs are eliminated in the United States. Based on that estimate, a $100 billion trade deficit will result in the loss of 2.5 million jobs and an increase in unemployment, welfare, and other social costs approximating $10 billion.

The losses in tax revenues and increases in social costs associated with an increase in the U.S. merchandise trade deficit from $40 billion annually in the 1977-82 period to $100 billion in 1984 can be expected to have an adverse impact on the U.S. budget deficit of approximately $20 billion. A $20 billion deterioration in the budget deficit, attributable to this country's worsening position in international trade would offset most or all of the fiscal benefits the Congress has sought to accomplish through curtailments in non-defense spending.

U.S. AND JAPAN EARNINGS AND TAX RATIOS

(MARRIED PERSON WITH TWO CHILDREN)



Source: Ministry of Finance, Japan

As U.S. trade deficits have grown, it has frequently been asserted that the competitive position of U.S. products has been adversely affected by excessive U.S. wage rates. The proponents of that view rarely note that wages and salaries in the U.S. are taxed at rates about twice those assessed in Japan. Labor in the U.S. must earn significantly more than Japanese labor if it is to have comparable after tax earnings.

U.S. labor and the products it produces are today carrying a significantly larger share of the costs of defending Japan's home islands and critical supply lanes than are Japanese labor and the products it produces. That situation is worsening. The increase in U.S. defense expenditures in 1984 over 1983 will exceed Japan's total defense budget.

U.S. AND JAPANESE SMALL CAR TAX RELATED COSTS IN THEIR HOME MARKET

($5,900 U.S. Factory Price)

	U.S. Built	Japanese Built
Manufacturer Related		
Income and Property Taxes	$ 440	$ 440
Commodity Tax	—	575
Subtotal	$ 440	$1,015
Employee Related	1,110	230
Total	$1,550	$1,245

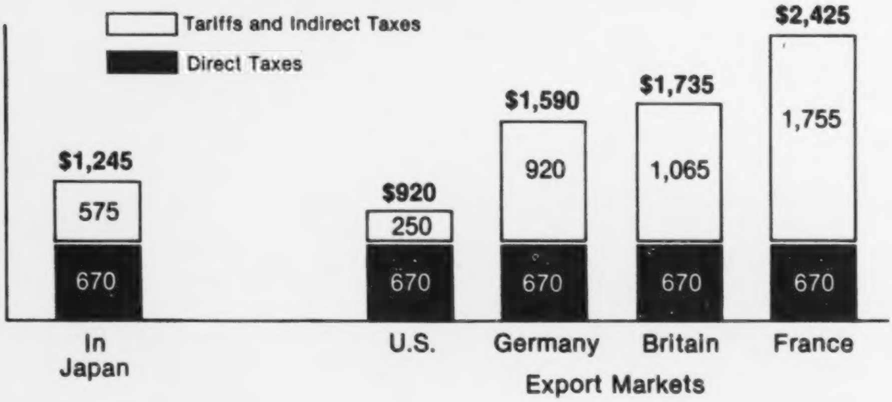
Source: "Doorstop for free trade"
Harvard Business Review
March-April 1983

Differences in total tax levels and in the manner in which taxes are assessed have a very substantial impact on the tax-related costs that must be recovered when automobiles produced in the U.S. and Japan are marketed.

A U.S.-built small car would carry with it to market about $1,550 of tax-related costs if it were sold in the U.S. Property and corporate income taxes paid by U.S. manufacturers account for about $440 of that tax burden. The remaining $1,110 is attributable to employee-related tax costs such as the social security and unemployment taxes that U.S. employers pay on behalf of their employees and the portion of their wages that automobile workers pay to federal, state and local governments in the form of income and social security taxes.

A comparable car would carry a tax load of only $1,245 if it were built and sold in Japan. Japanese manufacturers incur most of their tax costs in the form of taxes on profits and an excise tax (called the commodity tax) that they are required to collect at the time of sale in Japan.

TAXES AND TARIFFS ASSESSED ON SMALL JAPANESE CARS

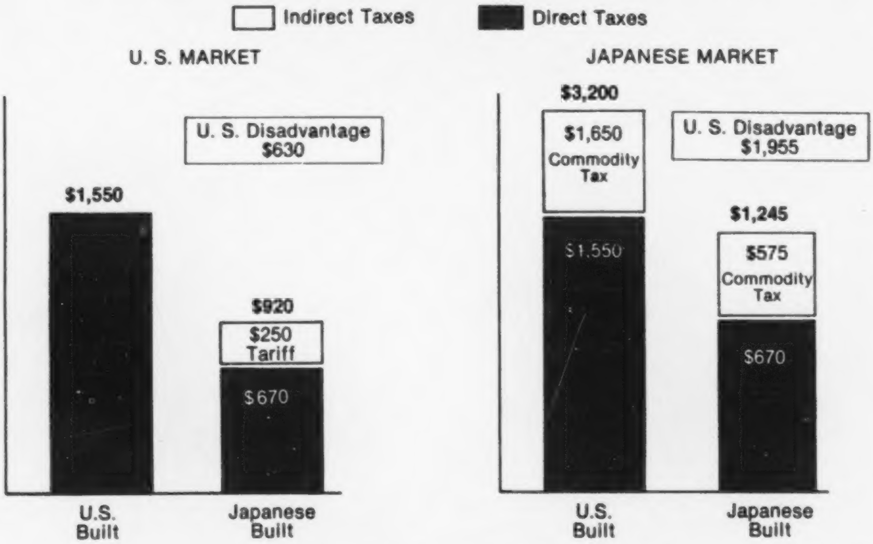


Source: "Doorstop for free trade"
Harvard Business Review
March-April 1983

International trade rules permit nations to rebate indirect taxes but not direct taxes at the time a product is exported and to assess indirect taxes but not direct taxes on products that are imported. As a result of these conventions, a Japanese-built car that would carry taxes totaling $1,245 if it were sold in Japan would incur a tax burden of only $920 if it were sold in the United States. The car would qualify for a $575 rebate of Japan's indirect commodity tax when it was exported and because the U.S. tax system relies on direct taxes, it would incur only about $250 in tariffs and duties when it entered the U.S.

If the same car were exported to Western Europe, it would incur a Common Market tariff and be assessed European value-added taxes which are classified as "indirect." In Europe, it would incur tax-related costs totaling $1,590 if it were sold in West Germany, $1,735 in Great Britain, and $2,425 in France. The United States is the only industrial nation that does not assess substantial taxes on imported automobiles.

U. S. AND JAPANESE SMALL CAR TAX-RELATED COSTS WHEN SOLD IN U. S. AND JAPAN



Source: "Doorstop for free trade" Harvard Business Review March-April 1983

A $5,900 small car produced and sold in the United States incurs tax-related costs totaling $1,550. In the U.S. market, the U.S.-built car is at a tax disadvantage totaling $630 per unit relative to a Japanese import that incurs Japanese and American tax-related costs totaling only $920. If the same U.S.-built small car were exported to Japan, it would incur tax-related costs totaling $3,200 and be at a disadvantage of $1,955 per unit relative to a small car produced and sold in Japan.

An automobile manufacturer cannot incur excessive material, labor or overhead costs and compete effectively with a more efficient producer that prices its product aggressively. Exactly the same condition exists with respect to tax-related costs.

As individuals, U.S. consumers may benefit from the tax advantages that imported cars enjoy; but as a group, U.S. consumers lose. U.S. federal, state, and local governments collect taxes totaling some $1,550 when a U.S.-built small car is sold domestically. They collect only $250, or $1,300 less, on the sale of an imported car. If government services are to be maintained, the tax losses and the added unemployment and welfare costs associated with import sales will have to be recovered from other taxes and it is U.S. consumers as a group who will pay those other taxes.

CONCLUSIONS

In his book, The Amazing Race, Professor William Davidson of the University of Virginia notes that the United States is engaged in a "two-front war." In the military arena it must compete with a USSR that neglects its industry to focus on military supremacy and in the industrial arena it must compete with a Japan that neglects its military to focus on industrial supremacy. U.S. trade policy, however, has failed to recognize that reality.

The United States has incurred huge merchandise trade deficits during a period in which its labor force was the most productive in the world, and its energy costs were the lowest in the industrialized world. It has incurred those deficits during a period in which it benefited from domestic raw material resources far greater than those of the other industrialized nations and in which its abundant agriculture made it far less dependent on imported food.

If there were free trade in the world, the U.S. would not be struggling today to control huge trade deficits. The world, however, does not have a free trade system; it has an administered trade system. Other nations have sought to minimize unemployment at home and earn the dollars needed to pay for imported oil by rigidly limiting imports and aggressively promoting exports. U.S. trade policy, on the other hand, has been governed by a "Marshall Plan" mentality that continues to view the U.S. economy as being so strong as to be immune from injury regardless of the inequities that the U.S. accepts in international trade.

The time has come for the United States to respond to all of the causes of huge and growing U.S. trade deficits which include the exclusion of U.S. products from foreign markets, an overvalued dollar, and inequitable international trade tax conventions.

If effective action is not taken, public support in the United States for protectionist measures that could seriously damage the world trade system will continue to increase and the ability of the U.S. economy to support essential social and defense programs will continue to diminish.

Chairman GIBBONS. Well, those are some amazing figures and we will certainly be taking them into deep consideration as we go forward in our tax and trade roles here. We will see what can be done.

Mr. Spencer.

STATEMENT OF EDSON W. SPENCER, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, HONEYWELL, INC.; MEMBER, BUSINESS ROUNDTABLE TASK FORCE ON TRADE AND INVESTMENT; AND MEMBER, EMERGENCY COMMITTEE FOR AMERICAN TRADE

Mr. SPENCER. Mr. Chairman, I am Ed Spencer, chairman of Honeywell.

Chairman GIBBONS. Yes, Mr. Spencer, Mr. Frenzel regrets very much he had to go over and vote. I will explain to you, that is one reason my vote record goes to hell. [Laughter.]

Mr. SPENCER. For the record, you should know that I have lived and worked abroad for many years, and I was a member of the first Wise Men's Commission appointed by President Carter and Prime Minister Ohira and am now chairman of the United States-Japan Economic Advisory Council.

I have been asked to discuss two areas with the committee today. The first is United States-Japan economic relations from the perspective of the Japan-United States Businessmen's Conference and our Economic Advisory Council, and the second is the policy decisions needed to maintain international competitiveness of U.S. high technology industries, in which my company has a major stake.

1. UNITED STATES/JAPAN ECONOMIC RELATIONS

First of all, United States-Japan economic relations. The trade situation between the United States and Japan receives a lot of attention in the debate on our trade deficit. This is because Japan must export industrial products to pay for fuel, food, and raw material imports. Competitive industrial exports inevitably enter the huge U.S. market in competition with our domestic industries.

Regarding Japanese competition, let me emphasize two points. First, the exchange rate question is not only a dollar-yen issue. The dollar's strength has grown relative to many other key currencies as well as the yen.

Second, the recent growth in the trade deficit is due in major part to a strong U.S. economy and to weak economies in Europe, the Middle East, and Latin America. Of our trade deterioration from 1981 to 1983, only $4 billion was due to growth of the deficit with Japan and $20 billion was due, for example, to deterioration in our trade with high-debtor Latin American countries.

From business experience in Japan and work with the Japan-United States Businessmen's Conference, which I cochair, I have some observations on relations between the United States and Japan that I hope will be helpful. That group consists of 200 or so senior executives from each country interested in United States-Japanese trade and generally supportive of the world trade system that has grown up since World War II.

We meet semiannually, discuss issues, publish papers, and promote trade interests with our respective Governments.

Last year the group issued recommendations on trade laws, practices, trade in services and agriculture, and this year we are taking a look at industrial policy in both countries.

The first observation is that the very size, complexity, and interdependence of economic and political relationships between the United States and Japan are inevitably going to lead to friction between us. We will continue to be major customers of each other and at the same time keen competitors.

Second, to cast Japan as a principal cause of our domestic and international trading problems is to do ourselves and Japan a disservice. Rather, we should learn from the trade deficit with Japan the things that we need to do to make our economy more competitive, on the one hand, and the points we need to negotiate hard to get improved access to the Japanese market, on the other. With regards to our ability to sell our products in Japan, our trade negotiators have been successful in reducing some barriers to U.S. exports, but more needs to be done to negotiate down old protectionism and to prevent the growth of new restraints. The Japanese negotiators play hard ball at the bargaining table and we have to continue to do the same.

Third, like the United States, Japan is undergoing a profound industrial change. For example, shipbuilding and textiles are no longer leading Japanese growth industries. Their steel industry is beginning to feel the pinch of low-cost competition from emerging economies. Aluminum has already been cut back. Restructuring is underway in chemicals and petroleum. There are articles appearing in the Japanese press about future problems of absorbing unemployed auto workers when that industry is no longer internationally competitive.

In the future, Japan and the United States will be increasingly competitive in advanced products made from new technologies. Competition will be within the borders of the two countries, as well as against each other in third countries. Because we both are developing these high-technology industries at about the same time—and because Japan and our country must export to maintain our high standards of living—that competition is going to be very vigorous.

2. U.S. HIGH TECHNOLOGY INDUSTRY

Now, I want to turn to U.S. high technology and what our competitive position can be in these types of industries that are represented by my company. We still have the world's largest and most productive economy. Our economy has recently made a dramatic recovery from a deep recession. GNP has expanded, inflation rates are down and the number of people employed has grown—in contrast, for example, to Europe. The unemployment rate remains high, though it appears to be dropping.

Our competitive position for advanced technology industries is particularly strong. Some figures illustrate this.

The National Science Foundation recently noted that high technology industries are providing twice as much productivity growth rate and three times as much real growth when compared to conventional industries.

The Census Bureau reports that U.S. exports of data processing equipment and parts in 1983 were $10.9 billion, imports were $4.4 billion, for a positive balance of trade of $6.5 billion.

Finally, the health of high-tech industries can also be seen through a number of new entrepreneurial firms in the field. We have a venture capital market without equal in our country.

The United States like Japan, is clearly moving from brawn to brain industries. Our steel, auto and machinery industries are feeling pressures from lower cost, more modern, more productive manufacturers in other countries. Our competitive response must include greater use of modern manufacturing equipment and processes in the brawn industries. It also must include improved labor relations.

This restructuring is occurring without a formal U.S. Government industrial policy. A series of ad hoc temporary measures have been put together case by case and change is taking place under that umbrella.

The best industrial policy for our country avoids import quotas and restrictions and lets the market decide which industries expand and which contract. Government action should be temporary and designed to facilitate restructuring.

Protectionism protects the inefficient, deprives consumers of freedom of choice, and leads to retaliation. Legal remedies, including some of those proposed by the trade remedies bill, are available to help our Government protect American industry from unfair trade practices.

The lead in competitive improvement must come from individual companies, not from Government actions. We should start with the proposition that exporting is not important but essential to the economic health of our Nation. We also have to take a longer term perspective of the financial results of our public corporations. Finally, we have to think in new ways about management techniques, about relations with our fellow employees, and about producing high quality products.

Congress has taken some actions and can do more to help strengthen the climate for U.S. industrial competitiveness. Here are six examples:

One, accelerated depreciation schedules have already been enacted by Congress. Over a long period of time, they will increase the productivity and competitiveness of U.S. industry. While high tech companies benefit less from this change than other types of companies, many of our customers do benefit from faster depreciation, and this is not an insignificant factor for those of us who sell high technology products.

Two, DISC helps exporters' cash flow. We need a GATT legal replacement with forgiveness of accumulated deferrals. The current foreign sales corporation proposal appears to accomplish these objectives. I hope this committee will approve the legislation this year.

Three, the R&D tax credit is valuable to all industry, not just high technology. The credit is now scheduled to expire in 1985. It should be made permanent. Legislation should also make permanent the suspension of IRS regulations on the allocation of R&D expenses to foreign source income.

Four, antitrust barriers still exist to the conduct of joint R&D. While joint ventures, such as the Microelectronics & Computer Technology Corp., have been created with Justice Department approval, we still need legislation to remove uncertainties. The House Judiciary Committee recently approved a bill which we believe should help.

Five, licensing barriers to exports need to be reexamined. High technology is no longer a market monopolized by the United States Export controls that are not coordinated with our allies not only harm U.S. firms, but they are ineffectual. The House-passed Export Administration Act is a good bill on this subject.

Sixth and finally, as has been said earlier, the most important action Congress can take to improve international competitiveness is to reduce the Federal budget deficit.

Thank you, and I look forward to discussing these issues further with you.

Chairman GIBBONS. Thank you, Mr. Spencer.

I will buy your industrial policy. "Industrial policy" has become a buzzword around here as a solution to all problems, real and imagined, and I think you have put it in the proper perspective. We do not need anybody telling us who are to be the winners and who the losers around here, or trying to tell us which direction to go. This is far too complicated a system for us to be intervening in. So I like your solution to that.

I think we can move on the fiscal policy this year. While I do not have that bill directly under my control, I will be pushing to make sure that it does get consideration at the appropriate time to get up and get passed, because I know the uncertainty that has been created there.

And I am proud to say that the Ways and Means Committee took a step a month ago to signal to the rest of the Congress and to the American public that we were ready to move. That 1,023 pages of tax simplification that we turned out here about a month ago will increase revenues by about $50 billion over a 3-year period. But it is just a statement on our part that we were prepared to move if the rest of the Congress was prepared to cut the spending.

Now, we are going to have trouble holding that line, because the spenders always seem to have the more popular appeal. But that is the purpose of turning that legislation loose and I hope that it will continue to be our purpose. We need you to reinforce us on that.

I am worried about what the size of this trade deficit will do, for a number of reasons. One, I am worried, are we in effect decapitalizing our farms and our factories?

Two, I know that there is a tremendous push for additional protectionism. For instance, I am going to have to hold some hearings on the steel matter right after these. I do not know where the votes on my subcommittee are on steel. I hope I know where they are.

And I get requests from the textile industry and from everybody else saying, we just have got to have more protection, we are overwhelmed, we are overwhelmed. And then some of the Government witnesses last week predicted that the trade deficit would, because of the momentum that has already developed, go much higher than it is. And while the wringing of hands has not been as bad as I thought it was going to be with this $100 million deficit, I am not sure how much longer that can be contained.

And as the political picture begins to get in better focus, the pressures get greater and greater on us. But I hear your unified message loud and clear: Get that U.S. fiscal deficit down. That is the first and foremost cause. Get rid of barriers that in effect make it difficult for you to contain your labor costs.

I am concerned about the figures you gave us, sir, about the basic inadequacies of our tax system as it relates to imported products versus our domestically produced products. And we will put our new economist to work on that and see what we can do to bring out some suggested changes in it if we concur in your beliefs.

All of you have some contact with the Japanese Government, and I am concerned that our Government has been late, but is now coming in strong, thank God, on the message that the Japanese have to do something about their yen. We are not talking about manipulating it.

As you know, this panel went to Japan last year and we took your message over there with us, and we found the Japanese officials rather skeptical, because they were not getting the same message from our executive branch. But now, thanks to your leadership, they are getting that message. But they have been very slow in making the changes.

Do any of you have any suggestions as to what we could do to make our voice perhaps better heard by the Japanese people on the need to internationalize the yen and to take off the artificial restraints that they have imposed upon it strictly for their advantage? What can we do? Does anybody have a suggestion?

Mr. MORGAN. I think more of the same, Mr. Chairman. The message that you carried to Japan a year ago or so was, I am sure, heard. And I agree entirely with your analysis that it took quite a bit of time for the administration to come on board this subject.

But the President sounded a very clear signal in his conversations with Mr. Nakasone, and we think that the rest of his team is coming on board in very good fashion here.

I would express a concern that they might become tired of the issue. And I can tell you from personal experience that it is one that requires durability and consistency and probably some of the tenacity of some of Bob Kilpatrick's better life insurance sales representatives. And I would only hope that the administration did not lose interest or settle for a quick victory and an inadequate one.

But I frankly do not see any particular solution through the legislative process. I think we ought to use the powers of persuasion and of logic and give the Japanese every opportunity to respond, to react as responsible world citizens, which I would have some hope that they will do. And I am sure Ed has some additional thoughts on this subject.

Mr. SPENCER. I agree with Mr. Morgan, Mr. Chairman, that legislation is not the key to untangling this protectionism of the Japanese yen from international money movements and international interest rate trends. What we are really up against is the systemic nature of the Japanese financial control system, which is aimed, in my opinion at least, not at having the yen weak and the dollar strong, but it is aimed at maintaining low domestic interest rates so that they can finance those very highly leveraged balance sheets at a minimum cost.

And most of the businessmen that I deal with feel very much the way we at this side of the table do. They want to see the yen internationalized, and this includes people in the banking community as well. They themselves—and obviously Prime Minister Nakasone has made a commitment to do what he can.

But they are up against on the Japanese side a very strong and very entrenched bureaucracy in the Ministry of Finance that has maintained control over their banking system since the very short capital days after World War II and is very reluctant to see their role in managing the internal domestic fiscal policy get out of their hands.

I think progress is being made. I also agree that we have got to be very careful not to try to overpower the issue and cause them to put up bureaucratic walls that people will not budge from.

I am inclined to think Secretary Regan's recent strong pronouncements are a part of the bargaining process that is necessary. As I said in my remarks, the Japanese play hardball at the bargaining table and we've got to do the same thing. And maybe even the suggestion that we might not look too favorably on their increasing their voting power in the World Bank might be the kind of an issue that would cause some of the bureaucratic people, the bureaucrats in the Ministry of Finance, to modify their views.

But I think progress is being made and I think it will continue to be made. My only concern is that it is not being made fast enough, and I think that we as businessmen, and Japanese businessmen as well and our administration leaders have to keep the heat on to see that it happens.

Chairman GIBBONS. I appreciate that. And you know, being from the land of beef and citrus, I can hardly condemn Ambassador Brock's making such an issue out of the citrus and beef thing. But I hope our Japanese friends will not think a few oranges and a few ounces of beef are going to really solve the problems between us.

And this citrus-beef thing is being blown so far out of shape that, despite my own parochial concerns for those matters, I do not want anybody to interpret that as being my policy or the policy of this committee or the policy of this Government, that a few oranges and a few ounces of beef are going to make any difference at all in this whole picture. I realize the value of symbolism, but I do not want our Japanese friends to settle behind a curtain of complacency if they happen to give in on a little citrus and a little beef.

I would like to say in self-defense, I have never heard that that would be our principal bargaining position, and I guess I feel uniquely sensitive in that area. But I hope that you all will make it clear to the business community that that is not what America is really looking for, that it is going to need some good signals, but citrus and beef is just not a solution to the basic fundamental problems that we have in that area.

Mr. Schulze, excuse me. Bill, I explained you had a better voting record than I did and had to maintain it. So we will hear from Mr. Schulze first.

Mr. **Schulze**. Thank you, Mr. Chairman.

Thank you, gentlemen, for a very interesting series of testimony. When you look at a problem as massive as our potentially $100 billion trade deficit and try to look at the largest factors, and I see that we spend about $60 billion on oil, and people say to me, if we could use more natural gas and import less oil, more natural gas which is produced in the United States, we could cut that trade deficit by $10 billion, $20 billion, maybe even $30 billion.

I wonder whether you have given any thought to that or have any proposals along that line, any of you.

Mr. **Morgan**. Say again, Mr. Schulze.

Mr. **Schulze**. We import about $60 billion of oil, and if we have newly discovered massive reserves of natural gas, if we could use the natural gas instead of importing oil, that we could bring about some radical changes in the trade imbalance. I realize you are not experts in energy, and I do not want to throw one that you have not even considered, so let me move on to another one.

Mr. **Spencer**. I have one somewhat longer range thought on it. I cannot deal with the short-range implications on today's deficit, but it does point up the fact that our own oil reserves are declining, and eventually, our natural gas reserves may not fill the full needs that we have in this country some many years out in the future, and it points up the importance of the export industries, and building a world trade system in which we do have access to those export markets, just as Japan has shown they can do, and they import 97 percent of their energy resources in Japan.

Mr. **Schulze**. You all seem to agree that we have got to get the Federal deficits down, and along that line eventually we will have to do something in the tax line. If we were to act on taxes right now, I guess it is realistic to say that we would not raise taxes on individuals. Not only is it an election year for us, but a Presidential election year, which means we would probably dramatically increase taxes on business.

Would you be in here at that time saying do not do that to us? We want to get this down but, you know, tax those other guys, and cut programs, or cut defense, or do something, but do not tax us.

Mr. **Kilpatrick**. I can respond in part to that question, Mr. Schulze. The Roundtable's position for at least 2 years has acknowledged that in a general, conceptual, sense we probably are going to need additional revenues in order to get the deficit down to manageable proportions.

On the other hand, we have been equally persistent in saying that we are against revenue increases of substantial proportions until the spending side has been addressed adequately, and there we have focused in two areas. We support a stronger defense establishment, but we believe that we are spending more than we can afford. But primarily we have said that until spending for nonmeans tested entitlement programs is brought more into line with the ability of the Nation to pay, it is almost irrelevant where you set taxes. We simply cannot afford the programs we now have.

And these programs are going to consume the country economically unless they are dealt with. They have not been dealt with as of this point.

Mr. SCHULZE. When we do start increasing taxes, I am hearing more and more around the country interest from the business community on the value-added tax. Are you gentlemen hearing that, and what are your thoughts on that?

Mr. KILPATRICK. We are hearing a variety of tax revenue raising ideas being discussed, one of which is the value added tax. The Roundtable itself is actively working on ways in which we can participate in the real debate on taxes, which we believe will come after the elections.

Mr. SCHULZE. Bob, your company, being an international insurance company, I guess, has to deal with variances in currency on a daily basis. How do trade deficits directly affect you and your company on a day-to-day, or week-to-week, or month-to-month basis?

Mr. KILPATRICK. We are a service company, as you know so well. We provide a portion of the financing of American manufacturers that do business overseas. We provide as much of the insurance of those companies as we can, and so forth. Our success in the international arena is directly related to success of the manufacturers' ability to sell their products at a profit, so we are affected directly by the trade deficit because our customers are affected, if you will. If they thrive, we thrive, because they need more of the kinds of insurance we provide, and they need more of the capital that we can provide. If they do not thrive, as they are not now, then we suffer right along with them because they are our customers.

Mr. SCHULZE. Do you find that because of the currency valuation and the trade imbalance, your products are less competitive? Or is it mainly tied to the success of our domestic industry?

Mr. KILPATRICK. It is mainly tied to the success of our customers rather than our own situation, because we deal mostly in the local currencies where we operate, say, in Japan. Therefore, our situation is mainly tied to the ability or inability of our own clients to compete in the local economy.

Mr. SCHULZE. Thank you. Thank you, gentlemen.

Thank you, Mr. Chairman.

Chairman GIBBONS. Mr. Frenzel.

Mr. FRENZEL. Thank you, Mr. Chairman.

I want to thank the panel, and apologize for my spasmodic appearance, and to particularly greet my friend, Ed Spencer, of Honeywell.

Mr. SPENCER. I should probably say you will probably get my support, even though you did not hear my testimony today. [General laughter.]

Chairman GIBBONS. That is why I let you proceed. I figured he might have already heard it at one time or another. [General laughter.]

He acts like he has.

Mr. FRENZEL. Our thanks to all of you. I know how pressing are the demands on your time, and we appreciate having the advantage of your counsel here, and hope that we can do something with it. Running through each one of your testimonies was the strong warning about the deficit. We are working on that today, and again, part of the reason for my absence, and obviously the Congress is not going to be able to do a job other than the downpayment, whatever we do this year, and your suggestions on entitlements, et cetera, are absolutely critical if we are to make the first regularized payment after the downpayment next year, which I guess is going to have to be a significant one.

I did want to stress an item on page 7 of your testimony, Ed, on the DISC. The Senate has put a DISC replacement into its tax bill. The House has not done so. And I, like you and, I am sure, like the members of the panel believe it is absolutely essential that we make that change. The DISC or the FISC, its replacement, is, in my judgment, not a very attractive export incentive, but it is all we have got, and we have to move on it soon. I assume your advice for this committee would be to roll over and concede in the conference committee and accept something like what the Senate has offered. Is that correct?

Mr. **Spencer**. That is correct, and in fact it is not an insignificant factor in improving our cash flow from our export business, and we want to see a bill that is consistent with the obligations under GATT which the FISC bill does, and we would like to see a forgiveness of these accumulated deferrals that all of us in the export business have built up over so many years and are on our books.

But until something is done by the Congress, we are always worried about those deferrals coming back into taxable income.

Mr. **Frenzel**. Well, you are right, and if we are to make prophets of our European critics, we have to repeal that.

Mr. **Spencer**. I put it in the testimony because I do want to see the Committee take action on it.

Mr. **Frenzel**. And there is another point. Your next point on the same page deals with R&D credits, and under the House bill those would expire, as I understand it, and we have to find a way to spread those out if we want to provide some incentive to everybody. Again, I think our colleagues in the other body are doing a better job than we are in giving consideration to what you consider are very important matters.

Mr. **Spencer**. And the issue there, of course, is to make it permanent. There is always that uncertainty unless it becomes a permanent part of the tax bill.

Mr. **Frenzel**. Absolutely, and to go a little further with the DISC, and the export incentive, I assume that at least lurking somewhere in the background of a consumption tax or a VAT proposal by the Roundtable is the potential of that tax for forgiveness at the border for an incentive. Is that correct, Mr. Kilpatrick?

Mr. **Kilpatrick**. The Roundtable has not taken a position on any potential source of new revenues or the specific incentives which might be included.

Mr. **Frenzel**. At the moment, we are working in that area of tax policy rather than export policy.

Mr. **Morgan**. Mr. Frenzel, if I could interject and support and reinforce Ed Spencer's comment about the DISC and the replacement for DISC——

Mr. **Frenzel**. Please do.

Mr. **Morgan** [continuing]. One of the things that would be totally devastating, if I may say so, would be the notion that seems to be abroad in some quarters that these deferred DISC benefits should be recaptured and repaid, and I cannot think of anything that would first of all disadvantage the creditworthiness and the balance sheets of more companies than that single action. As a matter of fact, in the case of Caterpillar, it would represent an obligation by us of over $150 million, $157 million.

Now, perhaps even more important than that, however, is what this says to future exporters. I have always been of the belief that the principal benefit of the DISC and should be of the FISC is not only the contributions from a cash-flow standpoint that Ed mentioned, but the fact that it tends to attract people into the business. This country can very clearly use, I believe, a lot more companies' direct involvement in the export market.

This is a great untapped potential, I believe. So far it is mostly the larger manufacturing institutions that have gotten into this, but if this rug were to be pulled out from underneath the companies and all these deferred benefits were to be declared due, I cannot imagine how long it would take to attract people back into the exporting business, and certainly it would eliminate completely the interest of additional companies getting into this business.

I hope that therefore is not a serious proposal that has been made.

Mr. FRENZEL. I thank you for your statement, and I believe you are right. There have been one or two persons who have raised that issue. I think it is not a serious issue in the Congress, and that the repeal of the accumulated obligations is a high priority goal of everyone who is working on that bill.

My problem is that the House has never had hearings on it, and so I am using or I am abusing the privileges that the chairman has given me to elicit comment from you on that, so that at least we will be able to say when we go into conference that we have had some advice from leading industrialists who use the device and who believe that it is important to go forward with it.

And may I ask if that would be an erroneous statement, or do you all feel that way? Or is there anyone who does not feel that way?

Chairman GIBBONS. Will the gentleman yield?

Mr. FRENZEL. I will yield to the chairman.

Chairman GIBBONS. Let me say that if I had control of that bill, we would have had hearings by now, but I don't have control of that bill, unfortunately.

Mr. FRENZEL. If I could say to the chairman, I imply no criticism. I am merely trying to use the time allotted for the best purpose.

Chairman GIBBONS. Well, we may meet that bill in that format.

Mr. FRENZEL. And I certainly hope that they do. One other statement of Mr. Spencer's that I would simply like to stress, and I am not sure I can find it any more, but it refers to the current interest by the U.S. public and by all of us to criticize the Japanese as much as possible for our troubles, and I have been accused in a nationwide syndicated column in my time of Jap-bashing, whatever that may be, but I do think we have to recognize this fact, that the growth of our deficit has occurred elsewhere than in Japan, which is the point Mr. Spencer makes on page 2 of his testimony.

For instance, I know now that our trade deficit with our good friends in Canada, our largest single trading partner, is, what, around $15 billion, getting up to where it is approaching the proportion of our deficit with Japan. In the meantime, in that rather short period, our plus balance in the same range with Europe has deteriorated to where it is now a slightly negative balance.

Chairman **Gibbons**. And the same with Mexico and many other countries.

Mr. **Frenzel**. That, I think, is pretty well understood, what has happened to us in the ADC's and the LDC's, but I think it is a good thing to make that point, and when we do so, we confer no glory upon the Government and the people of Japan for what I think is a dilatory practice of opening the markets, but I think we do have to look at the facts. There have been other things involved.

I wonder if you would comment, Ed, from your standpoint on various committees you serve on about what has happened to the Japanese market in the last 10 years, but more in the last 3 or 4 years. My impression is that American companies, particularly, say, medium-sized ones, have not been nearly as aggressive in going over there as the apparent opportunities would seem to warrant.

Could you comment on that?

Mr. **Spencer**. Well, I will talk in general about selling in Japan, exporting and manufacturing there. Some American companies have been very, very successful in Japan, and I could name—particularly in the high technology businesses, incidentally, and I would name people like IBM and Sperry and Burroughs and Honeywell and Texas Instruments and NCR and a number of others, and these kinds of businesses that because Japan is a big market for our kinds of products, we have been rather successful in selling there.

I would also say there are some other industries that the Japanese—and incidentally, our industries are somewhat more recent survivals on the industrial scene in Japan, not our companies. Most of us have been there for 20, 30, 40, 50 years. But the demand for our kinds of products came somewhat later in the Japanese economic recovery after the war compared to the automobile and the steel people who had a great deal of difficulty penetrating the Japanese at an early stage in that recovery, when they might have had much more successful business today in Japan if they had not been kept out at that early stage.

So, I think Japan has used protectionism in the early stages to provide an umbrella of protection for the development of their domestic industry from the wartime destruction, but Japan is a hard market to sell to. As you know, it takes patience and it takes a long-term look at the economic returns from that business, and I would only say there are lots of opportunities there.

It is my observation that at least in the high technology kind of businesses, that in addition to those big companies that I talked about in very recent years a number of small or medium-sized companies are finding some degree of success in the Japanese market. Certainly in the high technology industries we are not up against discriminatory protectionist practices like high tariffs. Tariffs in our industry have been dropping rather dramatically and almost to zero in some things.

Mr. **Frenzel**. We even have one company that sells soap over there pretty effectively.

Mr. Morgan, you have been the strongest single voice in America trying to direct Federal attention to the problem of the dollar versus the yen. Your testimony indicates that we have not been aggressive enough, or that—or at least not been successful enough, and I think I could agree with that.

What should we be doing that we are not doing? Is it simply that it is not a high enough priority with our administration? Are we not giving it the attention? Or are we asking the Japanese for the wrong thing?

Mr. **Morgan**. I think, Mr. Frenzel, we started off with a certain degree of awkwardness on this whole issue about 2 years ago, and the argument some of these solutions suggested were intervention. The word "manipulation" was thrown around in the debate. And finally, I think the parties began to understand one another a little more accurately, and ultimately focused in on the capital flow issue as being the principal thing that is going on and the principal part of the problem that we need to look at.

You asked, "What should we focus on?" It is, I believe, provable—although all economic matters of this type being subject to some debate, I suppose—that the Japanese do not have a totally free capital market, and that there is a certain amount of administrative guidance that is involved. Obviously, governments are entitled to regulate their fiscal, their monetary matters, and I do not complain or fault the Japanese for doing that.

However, the U.S. Government was early in this process dealing with the Japanese on the basis that there were essentially no controls, and that there was essentially a free capital market within the country. I think they have now come to the understanding that that is not true, and that has been the program that Don Regan and Beryl Sprinkel have been working on in their recent meetings and conversations both here as well as in Tokyo.

I think it is very apparent to me that interest rates in Japan are artificially low, and obviously they have to be protected from the outside demand in order for those to survive. They are not totally available, and so this is why, Mr. Frenzel, our program sort of comes down to three essential areas that ought to be emphasized in the ongoing conversations.

One is the internationalization of the yen. This is a world class economy. There is no reason in my thinking as to why that currency should not become internationalized. It is supported by an economically strong system. It is politically stable, and has all of the symptoms and qualifications for internationalization of the currency.

As I have already mentioned, capital market liberalization needs to take place, and this is being focused upon. In the conversations between Treasury and the Ministry of Finance in Japan, and the final leg of the triangle here is access to the financial sector of the Japanese monetary system.

Mr. **Frenzel**. Well, I thank you for that tour de force. This committee has agreed with you, and of course this is not your first experience here, but we have agreed with the broad thrust of the internationalization of the yen and the liberalization of the market over there. However, in liberating the market, we understand that we run some short-term risks, and perhaps we have run some of those already.

Our role, I guess, or at least as I perceive it, has been to be cheerleaders. We have carried the message to President Reagan and Mr. Nakasone, and anybody else that would listen to us, partly at your urging, for which urging we are very grateful, because I think you have played a key role in this particular matter. I hope that we will go forward, and I just thought it was important enough for you to restate for the committee.

Mr. Chairman, I know you have got a full list of people today, and I have run over a bit, for which I apologize, and again, I thank the panel.

Chairman **GIBBONS**. Mr. Jenkins.

Mr. **JENKINS**. Thank you, Mr. Chairman.

I want to apologize for having to go to another committee meeting a few moments ago very briefly, but I have read your statements and heard part of your testimony, and let me ask Mr. Spencer and probably others on the panel to clarify this. You indicate that our growing deficit is due to a lot of factors and that only $4 billion of our trade deterioration from 1981 to 1983 was due to the growth of the deficit with Japan.

What has been the situation with the merchandise surplus that Japan has run over the past 1½ or 2 years with Europe and the Middle East and Latin America? Has their trade surplus in the merchandise area grown during this period?

Mr. **SPENCER**. I do not have the exact figures in front of me, Mr. Jenkins. I will give you an impression. And my impression is that Japan is beginning to run into some of the same kinds of problems in the less developed countries, that we are running into the decline in those great projects in the Middle East that fueled the export markets in the latter part of the 1970's, and the decline in the ability of the countries in Latin America, for instance, to pay for the products that they were importing in the past.

On the other hand, I think Japan's trade surplus with the United States, of course, has gone up modestly in the last three years and with Europe as well.

Mr. **JENKINS**. With Europe as well?

Mr. **SPENCER**. Yes.

Mr. **JENKINS**. So while Europe has been in a recession, Japan has continued to increase its trade surplus in the merchandise area.

Mr. **SPENCER**. It certainly has.

Mr. **JENKINS**. Would that indicate to you that in addition to other reasons, that Japan has replaced some of our export markets?

Mr. **SPENCER**. I do not have any indication that that is the case, and I do not think the figures are big enough to indicate that that would be the case, but they are certainly very competitive in dealing with us and the place that they have the greatest advantage, of course, is the issue we have been talking about at great length, namely, the currency difference, where our products are higher priced than theirs in head to head competition in many cases.

Mr. **JENKINS**. It really makes no difference in our overall trade picture whether or not we have a smaller increase with Japan as compared to previous years. As you indicate, we only have $4 billion if, in fact, the Japanese have been able to replace our export market somewhere else.

Mr. **Spencer**. I am not prepared to say that is what happened. I do not know that that has happened.

Mr. **Jenkins**. It may be that Japan can say this is not our fault because we have only grown $4 billion, but if at the same time they have captured markets in other parts of the world——

Mr. **Spencer**. Incidentally, Mr. Morgan ought to talk about it, but this issue of the currency problem and the competitiveness of that is something that has cost us, whether it has cost us overall and how many billions in dealing with the Japanese, but you ought to hear a real time example of where they have deprived us of a formerly good market.

Mr. **Morgan**. Unfortunately, Mr. Jenkins, our industry is almost the prime example of the very point that you are making, because, like a number in the construction machinery industry, machine tools and heavy industry of that general type, a great many of us have presence in Japan which lets us take care of the Japanese competition for the Japanese market, and I think it is interesting or useful to suggest that there are really three components of this problem that are very obvious and simplistic, but forgive me.

There are the Japanese competing in the United States for what has historically been U.S. business. There are the attempts by the American companies to compete in Japan for business that is generated there.

And then the third one, which your question deals with is the Japanese and the Americans competing for third country markets, and it is that latter part that has really been very devastating, primarily from the currency exchange rate situation, because we are obviously, whether we bill in yen or dollars or whatever, we are ultimately concerned with the dollar and the competitiveness of operating from the United States, and the Japanese are in most cases competing from Japanese sources.

And it is their cost and their productivity and quality and all the other elements that are judged versus those same things obtainable from a U.S. source, and we have absolutely gotten killed in those third markets. Ed Spencer refers to horror stories. I will save you from them, but many, many transactions in our industry are at less than the out of pocket cost of production in this country. Those are the transaction prices that the Japanese bring to these third country transactions, and it is frankly impossible to overcome them in the short term.

Our view has been, and I touched rather briefly in a somewhat obscure way in our statement on this, that most thoughtful American companies are not asking this exchange rate realignment to solve the total problem. At our company, I feel that about half our competitiveness problem in these third countries where we run into the Japanese, about half of that problem is due to the currency misalignment problem.

But the other half is, I believe, clearly our problem, our industries' problems and the managements of the companies that are in those industries. And so we have always tried to make it abundantly clear, particularly when in the early days of some of the conversations with the administration in seeking their understanding and concurrence that something needed to be done on this, we have always tried to make it very clear that we were not asking for the whole problem to be solved.

That is why my statement included the notion that it is vitally important that there be an environment which will stimulate and make it possible for American companies to do what they need to do to be competitive at a reasonable exchange rate, because any reasonable adjustment in the exchange rate is in a great many cases not going to solve the total problem.

John Nevin referred to certain tax disadvantages that are especially applicable in the automobile industry. That, too, is a component, and the access to export controls which let us reach in our particular industry certain markets. We have been disadvantaged from time to time on economic embargoes and things like this, but it is very important that the U.S. companies should have a good business environment so that they can become more competitive and solve their part of the problem. But the other part of the problem rests with the exchange rate.

And so I wanted to make that compartmentalization of the various responsibilities and various contributions that we think can be made to this overall problem and return this 2, 2½ million jobs that we think have been lost during the deterioration of the export performance.

Mr. JENKINS. I appreciate your statement. It seems a bit ironic that almost every witness heard has attributed a great portion of the difficulty to the worldwide recession, which I accept. Yet at the same time, the United States being an exporting nation and Japan being an exporting nation, our balance has been deteriorating during this worldwide recession and it does not appear in the merchandise exporting segment that Japan has been deteriorating at all with the rest of the world economies.

Maybe my conclusion is wrong, but it disturbs me when we say Japan is not really hurting us too badly, but they do not seem to be sharing much of the export difficulties that we face with the rest of the world.

Mr. MORGAN. Certainly from our perspective that is very clear, and it is a harsh term, but I believe one of the reasons that they have not suffered as much in terms of export performance again in the heavy manufacturing type of product which I feel most confident in is because they in part have certain earned advantages, but they also have—vis-a-vis certain American companies—certain unearned advantages. And I would nominate the misalignment of the currency as the principal unearned advantage that I believe they have.

Chairman GIBBONS. And they do not have some of these silly export controls that we have.

Mr. MORGAN. That is right.

Chairman GIBBONS. I hate to think of what that embargo did to the U.S. reputation worldwide as a reliable supplier. That is going to cost us billions and billions of dollars worth of sales in the future.

Mr. MORGAN. We had 85 percent of the market in the Soviet Union, a significant market, and through the process of economic embargoes and the threats of economic embargoes, we transferred the 85 percent to Japanese companies and wound up with their 15 percent.

Mr. **Jenkins**. I would agree with the chairman's statement. I would also make the observation Japan does not have responsibility for its own security, and we do that for them, so they do not necessarily have to be as concerned as we are in some of these measures.

Chairman **Gibbons**. If the gentleman would yield, the point I want to make with export controls is that you had the market, you were supplying it. For some reason that I have never figured out, we slapped on the export controls. We destroyed the market. The Japanese immediately moved in and took the market, and we destroyed our reputation as being a reliable supplier.

Mr. Frenzel and some of us have just completed a tour of Eastern Europe, and never in any place do you see the ridiculousness of some of these export controls as you see perhaps in Hungary. We went through a fine plant there that was full of American machinery, exporting a product worldwide even to this country from Hungary, a complicated piece of equipment, a well-run factory.

The machine tools were guided by Japanese and German computer controls because we had refused to sell them the computer controls to go with the machinery. We got over to one bay of the factory. They were clearing out all of the machinery there, and I asked the plant manager what was the trouble, and he said, well, we are replacing that machinery, and I asked him again, I said, where are you going to get your machinery, and he said, from Japan.

And I said, well, why? And he said, we love our American machinery, but the Japanese will sell us a complete machine tool with all of the controls. We will not have to go to the Japanese and the Germans to get our controls for the machine tools, and we need to replace some of our machine tools.

Well, that is repeated over and over again around the world, and I appreciate your support of the House version of the Export Control Act. As bad as it is, at least it is not as bad as that Senate provision.

Mr. **Morgan**. We would certainly like to see some action on the Export Administration Act. I am sure that is no news to you.

Chairman **Gibbons**. I sometimes think that if the whole thing would die, we would be better off, but I do not know what needs to happen.

Excuse me, Mr. Jenkins, I did not mean to usurp your time.

Mr. **Jenkins**. I have no further questions, Mr. Chairman.

Chairman **Gibbons**. Mr. Pease.

Mr. **Pease**. Thank you very much, Mr. Chairman.

I, too, would like to apologize for not being able to hear your testimony in person.

You concentrated this morning on the problem of the Federal deficits, and we are over on the floor trying to do something about that today, and I was engaged in that practice.

I would like to particularly welcome a good Ohio company, Firestone, and Mr. Nevin, and express my appreciation in particular to Mr. Nevin and to his company for cosponsorship of a very fine conference on economic revitalization which we had in Ohio about 2 weeks ago. It worked out very well.

I think it is good to have you folks with us today. It is encouraging to me to see the broad agreement among the Government witnesses we had last week, the business witnesses we had this week, on the causes of our problems, and on the solutions. It seems to me that when we get a consensus, we have a basis for moving ahead and trying to do something about our problems.

I am particularly interested in your comments about barriers to trade. Mr. Nevin, you pointed out two barriers, or pointed to barriers to trade, as a significant problem. When we think of barriers to trade, we often think of Japan, and yet I know Mr. Spencer in particular said that we should not overemphasize problems with Japan. Could you, or anybody else on the panel, give us some idea of where our major problems are in terms of trading partners who impose artificial barriers on our exports?

Mr. NEVIN. Well, sir, I think that the Japanese have taken more punishment on this subject than any other country. I do not think I am expert enough on trade barriers in other countries to make a judgment as to whether that punishment is deserved, but I think that it is very hard to pick up the papers without coming up with one after another of what I would perceive to be impossible situations in terms of the openness of our market as compared with other markets.

This morning there was an article on, after all of the discussions over the baseball bat controversy, that we are still not able to get baseball bats into Japan. I think it was yesterday's or today's paper described the fact that after the controversy over the taxing of American cigarettes and the inability of American manufacturers to sell cigarettes in Japan, that the action that had been taken was to take a government monopoly and make a quasi-government monopoly out of it, but to leave all of the taxes that would cause the American cigarette to have twice the cost in place.

I read again and again of a continuing controversy with respect to telephone equipment. I would like to share or support Chairman Gibbons' comment with respect to beef and citrus. If I might make an observation, I think that one of the things that we forget about the Japanese is that they are a political democracy just like we are, and the form of that democracy may differ from ours, but they are indeed a political democracy in exactly the same sense that we are.

And their elected officials have to proceed with as much caution as ours if they want to buck the deep views of the people. I think that no one who has been to Japan or spent any time with the Japanese who is not left with the impression that they perceive themselves to be an island people who are beleaguered and who are short of raw materials and who have economic difficulties—now, it may be incongruous for us when we see their industrial power, but I think most observers of Japan would say that even their most sophisticated people think of their country as being one that must defend itself, must be cautious.

I think it is unfortunate, sir, and I am outside of my area of competence, but I am going to address you anyhow, I think it is unfortunate for us to be creating the kind of issue we are out of 5,000 tons of beef. I think it turns out to be 1 ounce of beef per Japanese citizen. And it just—it seems to me unfortunate when we are confronted with a society that for historic reasons is frightened about being cut off from food supplies, for historic reasons is concerned that it is beleaguered, that now we take them on on so deep an issue as that.

You know, winning it is not worth anything to us, and what we impose is an argument that my judgment says is demeaning to the Japanese, that we would presume to go over and take them on on that kind of thing. I think military issues are like that.

Obviously, a shorter lived conviction of passivism or a low level of armament, but every bit as deep-rooted. Well, they have got a $10 billion defense budget, and if we got them to increase it by 5 percent, and if every bit of that 5—or, excuse me, got them to increase it by 15 percent, and if every bit of that 15 percent was applicable to some area of American expenditure, it would reduce our defense expenditures by 2 percent.

And I guess my observation on these things is that I think we may be putting more emphasis than our long-term friendship justifies on us going over to Tokyo to bully them to try and get them to take action to solve our problem, and less emphasis than our long-term interest and our friendship with their country would suggest we might put on what are the areas in which we can act unilaterally as they have acted unilaterally to protect basic national interests.

And I am just reluctant to support this we have got to get tougher and tougher with them kind of thing. I think that ultimately might be the most disruptive course of action we could pursue in terms of relationships with an ally, and incidentally, if I can make one other observation, very unproductive. It was only 7 years ago that John Connelly said if they will not import our beef and citrus, we will let them sit on the docks of Yokahama in their Toyotas and watch their own television sets. That has not happened, and I do not think that kind of emphasis on that kind of an issue is productive in terms of either our trade policy or our relationships with a nation that is very important to us and has been a very important friend to our people.

Mr. SPENCER. Mr. Pease, if I may add to Mr. Nevin's comments, France is a country in which our country has had a great deal of experience. We had a computer business in France that had over $1 billion a year in revenue and some 20,000 employees in France and Western Europe, and that company was nationalized by the French Government. Now, that is a pretty direct attack on American investment in France.

But in addition to that, in all of the years that we were investors in that company, we were under constant discussion and negotiation with the French industrial—Ministry of Industry about what I would call administrative guidance to increase our domestic content and decrease the dependence of that company on exports from the United States.

It is a way of life for the French bureaucracy to push in very much the same direction as the Japanese do, and the whole issue of exporting from the United States into some of the advanced developing countries like Brazil and Mexico and India, to take three very large markets, where our ability to sell there has been impeded by their limitations on the amount of capital that you can invest in a company and their desire for domestic content type legislation that ensures the growth of jobs in those countries.

So, I would say those are four examples of countries where we have many of the same problems that we do, or have in the past, at least, in exporting to Japan.

Mr. KILPATRICK. Mr. Pease, I would just add here from the service sector all of the same kinds of barriers that my associates are talking about are present in Japan and most of the major markets around the world. In the insurance business, for instance, it is virtually impossible to get a license to operate in Japan unless you acquired one, in most cases prior to World War II, because they are strictly trying to develop a domestic financial services business.

The same is true in countries like Korea, with which we have a special relationship. In Malaysia, for example, you may not have a majority ownership in a company there. It can only be a minority participation. The same is true in Singapore and most other countries. In other words, it is a very nationalistic type organization.

Now, on the other hand, the same kinds of businesses that we are in, the Japanese can freely enter in this country. I am not advocating that we set up the same kinds of barriers, but we do need to keep hammering home the fact that what we really need is free trade, and eventually I think we will make some progress in that direction. But we currently must operate in an extremely restrictive environment, and Japan is not only among the most difficult to get permission to do business there, but you are also very, very restricted. I like the term that Ed used. Administrative guidance is very heavy in that country.

Mr. PEASE. Well, I think it is well not to overemphasize our relations with Japan for the very reasons that you have mentioned. Comparatively, is Japan a more difficult market to operate in than Europe or Latin America?

Mr. SPENCER. I think we could probably each say something different, depending upon our own company. We like it. We have been there 60 years. We have a high profit margin, a $500 million business. It has been a great contributor to Honeywell, and we have imported market shares in our kinds of product. So purely personally, it is a good place to do business.

Mr. PEASE. Better than Europe?

Mr. SPENCER. Better than some countries in Europe. In fact, our largest foreign affiliate is in Japan.

Mr. NEVIN. We have had limited experience in Japan. We had a joint venture there but with no problems in operating there. We have had widespread operations in Europe. There is no experience I have at Firestone that would say that Japan is a more difficult place to operate than Europe, sir.

Mr. MORGAN. Japan was more restrictive in terms of ownership for a good many years, and still has some vestige of that. So from that standpoint it is more difficult than Europe was, and still is a bit today. Other than that, it is essentially the cultural change that you have to adjust to, and many people find it a little easier to adjust to the European culture than they do the Japanese, and I think that that is inherent, and certainly nothing that they have arranged.

Mr. **Kilpatrick**. Japan is a difficult country in which to operate in the financial services business, but if you are to be in the international business, you must operate in Japan, and it is a relatively good place, on the other hand. But that is because there really is a thriving, growing economy in that country compared to most parts of the world.

Mr. **Pease**. Mr. Nevin, you pointed out that one of the underlying causes for the U.S. trade deficit is the exclusion of U.S. products from overseas markets. That is what we have been talking about. And I guess the question in my mind is, what do we do about it?

If you were in our shoes, if you were in Congress and writing the laws, to the extent that laws are a solution, what should the Federal Government be doing that it is not doing now, which is essentially jawboning, to try to get markets in other countries, Japan, Europe, Latin America, more open?

Mr. **Nevin**. Well, my answer, sir, would differ by part of the world. I think that there might be good reason for us to tolerate, even to endorse export or import restrictions in some parts of the lesser developed world or the countries that are attempting to get their financial houses in order, and I think that you could not apply to the nations of South America or the nations of Africa the same kind of rule.

I think that when our trade policy evolved in the immediate postwar period, Japan and Western Europe were in an economic position not unlike that which some countries in Africa and Asia confront today, and I think that there was at that point in time good reason for us to be very patient. I think there are only two areas of unilateral action.

The one is in making the playing field a little more even, and I congratulate this subcommittee on the actions it has taken to attempt to do that by providing better responses in the unfair trade practices area. This is going to be a minority view that will not be shared by my colleagues, but I think ultimately with a developed nation that excludes our products and assumes that its most competitive industry should have free access to our country, we ultimately are going to have to be prepared to accept something like reciprocity or simply say we cannot tolerate the impact of that, and again, I will say I am speaking for myself. I am not speaking for my colleagues in that area.

Mr. **Pease**. Does anyone differ from that?

[No response.]

Mr. **Pease**. Well, I am interested in that response. This subcommittee was in Japan just about a year ago. I have come to the conclusion from that visit and from a lot of other of my experiences that the Japanese are not likely to ease restrictions on access to their market. They talk a lot. We talk to them. We jawbone them, browbeat them. They make promises, but it is like the Dance of the Seven Veils. They take one veil off, and there is always another one behind it.

And so I guess for our country the policy is going to come down either to accepting and tolerating that attitude on their part with the consequent inhibitions on trade or to going to the sort of reciprocity approach that Mr. Nevin mentioned. That is going to be considered a very tough approach if we do that, and it will be considered protectionist. I guess I am interested to know from the panel which one of those two approaches should we really follow.

Mr. **Spencer**. Well, Mr. Pease, from my responsibilities in dealing with Japanese businessmen on various commissions and committees, I would say that the barriers have come down rather substantially, the legal barriers to doing business in Japan, in recent years. There are celebrated things that need attention, tobacco, et cetera. The businessmen that we deal with in Japan have just as much a stake in the free world trading system as we do, and they are pushing very hard for many of the same objectives that we push for.

However, I think American companies have to recognize that there are some things in Japan that are not going to change easily and quickly. The distribution system, for one, which all of us have had to find ways to circumvent, and I think another factor is the ability of Japanese companies to cooperate together under a legal framework in conjunction with a government that is impossible in this country.

And some of those things are not going to change because of reciprocity. I happen to disagree with Mr. Nevin, as he would expect, on that, because I think reciprocity is going to lead to retaliation, and that is something that I do not think any of us want. I think I favor the constant discussion, pressure, push, and some very tough bargaining at the negotiating table which is going on right now in Washington to try and make progress on these issues, and I think it works somewhat more slowly, but it works.

Mr. **Pease**. Thank you.

Thank you very much, Mr. Chairman.

Chairman **Gibbons**. Thank you. I hate to cut off the discussion, but we have got some other witnesses. We appreciate your contribution to all of this.

I want to say as one last observation that this is not any attempt to justify my own junketing, but I find that going around the world and looking at other economies, it helps me understand the mistakes they are making; and the mistakes we are making, and as I look at the Japanese economy, their vaunted progress has come out of the hide of the Japanse people.

The Japanese people are not living very well as individuals. If you get outside of Tokyo, it is a rather primitive society. No one in this country, even the welfare recipients, would put up with that kind of infrastructure and everything else. So I think the bottom line is that all of the substitute type practices that people take on have harmful side effects that we would be well not to try to emulate. And the effects of protection and of attempts to develop the import substitution types of industries that we see in some of the other advanced developing societies are all going to come out somewhere. There is just no free lunch in all of this.

So, I am happy with our system. It could be improved. And you have made some excellent suggestions as to how we could improve it, and we appreciate what you all have done. Thank you very much.

Mr. MORGAN. Thank you for your attention, Mr. Chairman.

Chairman GIBBONS. Our next panelists are both certainly no strangers to this room or to this subcommittee. Mr. Robert Hormats is the vice president of corporate finance, international, for Goldman Sachs, and Mr. C. Fred Bergsten is the director of the Institute for International Economics. Both of them have had distinguished careers in and out of government, and we bring you here to help throw some light on the predicament of how did we get into this position, how do we get out, and how much further do we have to go.

First, Mr. Hormats, we have you listed first, so we will take you first.

STATEMENT OF ROBERT D. HORMATS, VICE PRESIDENT, GOLDMAN, SACHS & CO., AND DIRECTOR, GOLDMAN SACHS INTERNATIONAL CORP.

Mr. HORMATS. Thank you, Mr. Chairman. It is a pleasure to be back before this committee and particularly to talk about an issue which I guess both Fred and I have spent many hours dealing with before this committee and others over the last 10 or 15 years—that is, U.S. trade and now particularly the problem of the U.S. trade deficit.

I think one of the interesting things it is useful to observe at the outset is that 15 years ago or so, the trade deficit was not an issue for most Americans because trade was a relatively small portion of U.S. GNP. Today that is no longer the case. It is a much larger portion of U.S. GNP and for that very reason the dollar is an issue which affects a lot more Americans than in the past.

The exchange rate with the dollar has an impact on jobs, on profits, in virtually every part of the United States, and for virtually every sector of the American economy. The figures that were discussed by the earlier panel with respect to the U.S. trade deficit, I think, are distressing.

The CEA predicts a trade deficit of about $110 billion this year, and given the latest statistics, the higher probability is that we will have a trade deficit of $120 billion or perhaps more. That has a dramatic effect on American jobs when one figures that for every billion dollars of lost exports, we lose about 20 to 25,000 jobs, and that is an awful lot.

It is particularly impacting on areas such as Lee Morgan's because a lot of the things that we do export or at least in the past have exported quite well are in such areas as machinery, heavy equipment, and things of that nature, and that is why a company like Caterpillar, when one looks at the dollar and the overall trade picture, is particularly hurting at this point.

I think it is also useful to look at the sectors that have been hit by the decline in the U.S. trade balance. Between the end of 1980 and the end of 1983 U.S. merchandise exports dropped by over 15 percent, capital goods exports by over 25 percent, and exports of agricultural products by 10 percent. It is the capital goods sector which has been hurt, I think, most dramatically by this.

The question of the dollar is one that has been debated, and I think there is good reason to be concerned about the overvalued or uncompetitive dollar, and there are debates as to whether the dollar is overvalued by 25 percent, or 30, or 35 percent. The basic point is that in trade terms it is very definitely overvalued.

The other distressing fact is that the traditional correction mechanism does not work or does not appear to be working any more. That is to say that in the past when the dollar is overvalued or any currency was overvalued, there was a correction mechanism. Trade deficits would emerge, and those trade deficits over time would reduce the value of the dollar.

Under a fixed rate system, it would reduce it because the country would lose foreign exchange reserves and have to devalue. Under the floating rate system, other things being equal, the dollar would, or the currency would, float down on the basis of the market forces. The fact, however, today is that capital movements dwarf trade flows in terms of their impact on exchange rates.

A recent figure indicated that in 1 month $700 billion worth of currency movements took place in the New York currency market alone and the New York currency market is only the fourth largest in the world. There are three bigger currency markets, so that the impact of movements of capital really has a much more fundamental impact on the value of the dollar. So, the dollar does not have the responsiveness to trade imbalances that it had in the past.

What does the dollar respond to? It responds to first, it is a safe haven for currency where people are concerned about instability. Second, people move into dollars when they want to buy American assets to take advantage of growth in the American economy. And, third—and the one that has been focused on here—people respond to interest rate differentials and particularly interest rate differentials that reflect potential movements in inflation in currencies.

So, it is that element that I want to talk about a bit. First, I would say one thing, and that is that the dollar now is in a relatively precarious state. We have seen a lot of volatility in currency markets. One reason is that as trade deficits build up, more and more money is in the hands of foreigners, more and more dollars are in the hands of people abroad, and as those dollar holdings build, people become a little more wary about the future of the dollar so that there is always a potential for a big run on the dollar.

That has not happened yet. It has been moving in hurricane jerks, but it can happen. And also, I think, this is a less appreciated point. Many more liquid dollars are in the hands of Americans than foreigners. We tend to look at the amount that is held abroad by foreigners, but if there is a concern about the value of the dollar, it does not necessarily mean that the foreigners will be the first to let the dollars go.

Americans may decide either to protect themselves or to make some profit that they will sell dollars and buy deutsche mark assets. So one should not just look at the amount of dollars in foreign hands to predict the possibilities of a decline in the dollar. It is the overall question of the precariousness of the dollar.

Let me just touch briefly on the question of the dollar and the trade deficit. As I mentioned, the self-correction mechanism does not work. What if this mechanism is not working and how do we make the system work? How do we equilibrate the system? There have been a lot of proposals.

Some propose import restrictions or subsidies; others propose government role in capital markets of some sort to influence capital movements, and one can understand why people propose those things because they are reacting to the major disparities in the value of the dollar vis-a-vis other currencies.

I guess the question really is what is the best way of dealing with the fundamentals? I very much agree with the panel that appeared earlier that the best way to deal with it, first and foremost, is to cut the Federal deficit, but we should be aware of the fact that there may not be a panacea.

The big problem—and I think I have looked at some of the numbers on the deficit—there is a debate in Washington now: Does the Federal deficit really have an impact on inflation or does it not. The answer is that in periods of slack you could have a large Federal deficit without much of an impact on inflation. The fact is today, however, and the numbers are interesting.

In 1965, inflation began to pick up or accelerate when capacity utilization was 86 percent. In 1972 recovery, 84 percent capacity utilization triggered upward movement of inflation. In 1982, between 80 and 82 percent, and now we are seeing a pickup in inflation at 79.5 percent capacity utilization.

This is precisely the time the Government should be reducing its share of borrowing and its share of GNP. Instead, it is moving up so that while the administration or those in the administration, shall I say, who argue the point that the deficit has no impact on inflation at times may be right, now they are dead wrong because this is exactly the time when Government should be moving out of the market so that the private sector can begin to borrow and build capacity. So you have the Government competing with the private sector for goods and for capital.

Now if the budget deficit is reduced you will see less demand for goods by the Government and less demand for capital, but the real question that affects the dollar is when this happens is what the impact is on interest rates vis-a-vis prices.

If demand for—if prices of goods go down at a more rapid rate than interest rates, then it may in fact lead to a strengthening of the dollar because real rates would be going up. If interest rates go down at a more rapid rate than the price of goods and the price level, then it will probably exert downward pressures on the dollar because you will see a narrowing of real interest rates. And this is an important factor.

So that the cutting of the deficit should be done for an awful lot of reasons. But it may or may not be a way of leading to a major decline in the value of the dollar.

Another question relates to Fed policy and this is particularly important. If the Fed does tighten up and raise interest rates it may well be that it strengthens the dollar in one respect, and that is that U.S. securities would be more desirable, U.S. fixed income securities, bonds and such things.

On the other hand, if it does that U.S. equities or people who want to buy investments will find themselves more positive toward the dollar because they will think that we will have a higher rate of growth and so there will be more demand for stocks and for real assets in the United States. So the Fed policy can have influences in different directions, depending upon the type of holder of the asset.

Then there is the J-curve effect which I am sure you are familiar with, and that is that even if the dollar does go down right away there will still be a lot of goods that will be purchased with the higher foreign cost, and that means that in effect the initial decline of the value of the dollar is not—does not necessarily mean that the trade deficits will decline. For a period of time, it will increase, although ultimately the deficit will improve.

So that while steps in the direction of a decline in the deficit are important, one should not regard them as a panacea. I think there is a lot to be said for a greater degree of cooperation among trade and financial and monetary authorities in trying to figure out ways of bringing currencies down into a more reasonable zone or relationship with one another.

I think that there was an attempt in the 1978 summit in Bonn to try to get a little bit more harmonization of policy. It was then called the locomotive theory, but one can call it anything. But the basic objective is each country's policies have an effect on the exchange rate among the major currencies. We have almost abandoned that and I think that is unfortunate.

I think both Fred and I have given a lot of thought to this and there are ways, in my judgment, without one country locking its policy into another or being dominated by another to have a greater degree of harmonization of policy mixes so that we can avoid exchange rates which fall into these danger zones and then the danger zones distort trade and feedback on domestic economies.

So I think that is an interesting area that needs to be pursued particularly because the London summit is coming up and it affords an excellent opportunity for trying to get cooperation to bring exchange rates down to more reasonable levels. You also have to have trade officials in there, too, because it should not be just left to financial and monetary people.

The second area that I want to talk about is one that is particularly important in the trade balance, and that is the question of the developing country debt problem as it relates to trade. When one looks at the numbers we have suffered over the last 3 years a reversal in our trade balance with Latin America of $21 billion, a turnabout between the trade surplus and a trade deficit of $21 billion.

And that has had an effect of probably 300,000, 350,000 American jobs in itself, and that is related not so much to the dollar but to the debt issue. The question came up have other countries also suffered a decline, say in export to Latin America. The answer is yes. The Japanese have also suffered a roughly 40 percent decline in their exports. The difference is that the Japanese relied less on Latin America for an export market than we do.

A lot of our exports are aimed at Latin America. So while the percentage decline is similar, the absolute impact on the American economy is much greater than for anyone else because Latin America is so important to us as an export market.

So I think much needs to be done to deal with the debt problem in Latin America. I applaud the efforts made by the administration and the Fed and the Latin countries and the commercial banks to deal with the Argentine problem. I think that was dealt with very pragmatically and very effectively, but we have got to develop medium and longer term solutions. I think everyone recognizes that.

That means we really need a much more active effort to support the IMF and let it borrow in capital markets and let it provide more assistance. We need to support the development banks. We certainly need a much greater Exim-type program for guaranteeing export credits, and we need to use the London summit or some other vehicle for getting other countries to do likewise, because we are simply not going to export much to these countries unless there is some degree of government participation in those credits. And I think that is important.

Also, I think it must be recognized that the banking community and the Federal regulators are going to have to find some way of allowing for a relatively low rate of interest and for a longer term payout of that interest because the fact is today that when developing countries, high debt countries, do earn more from, say, increases in commodity prices they use almost all of it to repay—not almost all of it but a very large percentage of it—to repay financial institutions, to repay their lending.

Now obviously they should do a lot of this, but we have to recognize that to the extent they do that they are not using it to buy new goods and therefore the multiplier effect of increases in their earnings is somewhat less than it has been in the past.

Finally, I think it is very important that we move ahead, and I know Bill Brock is trying to do this and I commend that, move ahead to establish some degree of multilateral momentum in the area of trade. One of the problems is, and it has been used in this committee before, trade is sort of like a bicycle. When the momentum stops, then it can lurch from side to side. That is what is happening now.

There is no multilateral momentum and, therefore, every country in the world is taking unilateral or bilateral action and this hurts us because other countries intervene more, for the most part, than we do. It hurts on the debt side, and everyone is hurt. The general level of world economic activity suffers for this.

And I have put in this testimony some thoughts that would urge us to get moving on some type of negotiation, perhaps a less formal type of negotiation than one that is traditionally used in the GATT but get moving in a way so that we can limit the damage which is currently occurring, reverse some of the damage which has occurred, and develop a process for prior notification of government intervention, monitoring of government intervention, and efforts to ensure that it does not hurt other countries and it is phased out or adjusted, the adjustment process works as quickly as possible.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF ROBERT D. HORMATS, VICE PRESIDENT, GOLDMAN, SACHS & CO., AND DIRECTOR, GOLDMAN SACHS INTERNATIONAL CORP.

Mr. Chairman, I genuinely welcome the opportunity once again to testify before this committee, which has done so much to focus attention on the importance of international trade to the United States and to steer U.S. trade policy in a constructive direction.

The problem before us today—the U.S. trade deficit—is particularly serious. It concerns virtually every American. It has an impact on millions of jobs in industry and agriculture, on interest rates, and on the foreign exchange value and stability of the dollar.

Fifteen years ago, the U.S. trade balance was of relatively little concern to the majority of Americans. At that time exports of goods and services accounted for only 4 percent of this country's GNP. Today that figure is roughly 9 percent. Large numbers of American jobs and businesses are sensitive, or vulnerable, to import competition. The $25 billion decline in U.S. exports from the end of 1980 to the end of 1983 cost the U.S. between 500,000 and 750,000 jobs.

Before discussing the reasons for this deterioration, let me briefly examine its dimensions and consequences. In the period between the end of 1980 and the end of 1983, U.S. merchandise exports dropped by over 15 percent, capital goods exports by over 25 percent, and exports of agricultural products by 10 percent.

The enormous U.S. trade deficit is pushing the U.S. into the position of an international debtor. That is, claims on the U.S. by foreign governments, individuals and corporations will soon be greater than claims by Americans on other countries. We will, in effect, be borrowing from the rest of the world. We will continue to add to our debt if large deficits on current account continue; and interest charges on our debt will further increase the burden.

A related concern about the trade deficit is that foreign holders of ever growing amounts of dollars could at some point decide—because of concerns over an expected increase in the U.S. rate of inflation, a decline in U.S. growth making investments here less attractive, or fears that continued deficits will weaken the desire of others to hold dollars—that they wish to sell substantial amounts of their dollar holdings. Or, and this is a considerably less appreciated point, Americans (who hold far larger amounts of liquid dollars than foreigners) could simply decide that the international situation of the dollar was becoming precarious, in part because so many were being held abroad. They could then, either in order to defend themselves against an anticipated dollar decline, or to make some profit therefrom, themselves sell dollars and buy foreign assets.

The point is that in the current uncertain circumstances large numbers of holders of dollars wherever they may be could move quickly to sell them in large amounts. In such an instance the dollar would weaken considerably. Some weakening of the dollar would, of course, be welcome—perhaps a drop of 20–25% over time—because it would likely improve significantly the U.S. trade balance, with a lag. But too sharp or steep a drop would raise the cost to the Treasury, and to the American taxpayer, of borrowing to finance the federal deficit—more than 10% of which last year was financed from abroad. And the dollar's decline would, as I shall discuss later, add to domestic inflationary pressures.

THE RELATIONSHIP BETWEEN THE VALUE OF THE DOLLAR AND THE TRADE DEFICIT

A major reason but not, as I shall make clear shortly, the only one for the deterioration in the U.S. trade balance is the extremely sharp rise in the foreign exchange value of the dollar over the last 3 years and, importantly, the apparent breakdown, or at best the slowness to operate, of the traditional "self-correction mechanism." Theoretically, and usually in practice, when in the past a country ran a large or prolonged trade deficit the foreign exchange value of its currency declined. Its producers would then be more competitive vis-a-vis their foreign competitors and the trade deficit would be reduced over time. Under the Bretton Woods system this exchange rate adjustment occurred because the deficit country lost reserves and was forced to devalue. Under a system of floating exchange rates, the market pushed its currency down. In either event, a decline in its currency value, assuming it was not offset by increases in inflation or otherwise invalidated, would improve its trade balance after a time lag and certain amount of domestic adjustment.

Today, that corrective mechanism is either not working or working with a very long delay. This is largely the result of the enormous influence capital flows have on exchange rates. Today currency movements dwarf trade flows in magnitude—one recent study found that in New York roughly $700 billion changed hands on the spot and forward markets in only one month. And New York is only the fourth largest foreign exchange market in the world. Capital movements are sensitive to such things as political factors, current and anticipated rates of interest and expected movements in exchange rates.

The failure of the self-correction mechanism to narrow trade imbalances has led to major pressures to "manage the system" to either reduce the trade imbalances directly by imposing import restrictions or export subsidies, or indirectly by reducing exchange rate misalignments through capital controls by countries with undervalued currencies. Such pressures are understandable in light of the competitive disadvantages imposed on the American economy by the high dollar exchange rate. The question which such suggestions raise, however, is whether these actions are really going to solve the trade problem, or is there a better way. The answer is that there are far more effective ways of addressing the problem.

The underlying causes of the dollar's high exchange value are that: it is a currency which serves as a safe-haven in periods of instability or threatened instability elsewhere in the world; U.S. recovery has made investment in this country very attractive of late thus adding to the attractiveness of and demand for dollars; high real interest rates in the U.S. have substantially increased demand for dollars to purchase high yielding securities.

It would not be sound policy to limit the purchase of dollars for safe-haven or investment objectives. But the interest-rate attraction can be addressed. There is a major debate in some quarters as to whether the federl budget deficit does in fact cause high interest rates. Administration spokespersons say that there is no historical correlation between large budget deficits and high interest rates; many critics hotly dispute this. In fact, the administration has a point. High budget deficits during periods of slack demand and low levels of capacity utilization generally do not raise inflation or interest rates; in such circumstances the government does not face vigorous competition from the private sector for goods or capital. But in the current situation, there is most difinitely a link.

Since the early 1970s inflation has turned upward at lower and lower levels of capacity utilization. In 1965, inflation accelerated when capacity utililzation was about 86 percent. In 1972 it was 84 percent, and in 1982, between 80 and 82 percent. Now we face an upturn at about 79.5 percent. At the time that this level is reached, government deficits should be close to balance, in surplus, or at least narrowing, because business needs to borrow more in invest in new capacity—thus demanding more capital and more goods. Thus, at precisely such a time governments should by reducing its relative demand for goods and capital, because its stimulus is no longer needed. Instead it is today actually increasing its demand for both. In so doing it is adding to upward pressures on prices and interest rates. If interest rates go up faster than inflation, that will exert upward pressure on the dollar. If the reserve occurs, the dollar will decline.

But a lower-valued dollar, while a major step in the right direction, is by itself no panacea. First, a decline in the dollar's value will itself add to inflationary pressures. It is worthy of note that the strong dollar of the last three years has lowered prices to U.S. consumers only modestly. While the dollar strengthened dramatically from 1980 through 1983, the price deflator for merchandise imports fell by only 3 percent from its spring 1981 peak to the end of 1983, and domestically produced goods which compete with imports rose by 8 percent. In the last year the price of imported goods actually rose by 0.6 percent and the price of domestically produced imported goods by 4.6 percent. Thus we are no longer getting the anti-inflationary benefits of the strong dollar, and can anticipate an increase in inflationary pressures from a weakening one. Countries which benefit most from a drop in the value of their currency are those which can avoid increase in domestic production costs that offset the competitive benefits which such a decline initially brings.

Then there is the "J-curve" effect, whereby the dollar's decline will initially increase the amount of the U.S. trade deficit. This effect occurs because dollar devaluation makes foreign produced goods cost more in dollar terms than they did before. While foreign producers will lower prices to avoid losing their share in the U.S. market, and Americans will shift some of their demand from foreign to domestic markets, they do not do so all at once. And foreign made goods already on order come in at the higher dollar price. The result is that the same volume of imports, or even a declining volume, will cost more in dollar terms than before the dollar's decline. This temporary drop in the trade balance constitutes the bottom of the "J", which must be experienced before we realize the benefits of the "J's" upward curve

It is also important to note the role of the Federal Reserve Board in the dollar's future. A tightening of monetary policy, by raising interest rates would attract more dollars into U.S. securities, thus strengthening the dollar. It would also reduce inflationary concerns, which often lead to a weakening of the dollar. But, to the extent that the Fed tightens up, it would also raise the expectation of slower growth, which would reduce the attractiveness of direct or equity investment in the United States, thus reducing the dollar's attractiveness to a certain group of investors. It is at this point difficult to calculate the size of currency movements resulting from any particular policy change by the Fed. But such analysis is necessary.

In the final analysis, the dollar/trade problem is likely to be solved by a more harmonious international approach to identifying the impact of the interface of monetary-fiscal policy mixes of the major economies on exchange rates and trade flows. We in the United States have until recently paid little attention to the dollar's exchange rate because, with a relatively small portion of our GNP affected by imports or exports, it appeared to many Americans to make little difference. Now, because in the last fifteen years trade has grown so significantly as a percent of U.S. GNP, most Americans know that the exchange rate can have a major impact on their jobs and the profitability of their firms.

We thus need to be more aware of the secondary, or "feedback", effects of monetary-fiscal policy mix. We need to better anticipate its impact on the exchange value of the dollar and thus on U.S. trade. And we need to consult better with other major trading nations to ensure that our exchange rates do not move into "danger zones" that result in trade distortions harmful to our domestic economies and cause intense pressures for protection to offset exchange-rate caused competitive disadvantages.

It is no longer a satisfactory answer to say that market forces will take care of exchange rates because those rates are so heavily influenced by government action in the first place. Nor will political forces, which must be sensitive to large trade imbalances and the harm done thereby to important domestic industries, be willing to wait for what appears to be an interminable period for the "self-correction" process to work.

Thus a process is necessary to permit nations to anticipate the secondary, or feedback, effects of planned changes in monetary and fiscal policy, to identify currency "danger zones" and modify policies when necessry in order to avoid these zones, and to see the maintenance of exchange rates which avoid such zones as one element of domestic monetary policy.

Senior financial, monetary and trade officials of the countries most actively involved in the trading and financial system should meet periodically to identify the zone of exchange rate relationships among them most likely to avoid major trade distortions and the types of fiscal and monetary policies most likely to keep rates within those zones. Having such collective judgements in front of policy makers could help avoid the imbalances in which are so troublesome today.

THE DEVELOPING COUNTRY DEBT PROBLEM AND THE U.S. TRADE DEFICIT

As noted above the dollar is by no means the only, or even the largest, cause of the deterioration in the U.S. trade picture. Between the end of 1980 and the end of 1983, U.S. exports fell by roughly $25 billion and the trade balance by far more. By far the largest decline in exports was to Latin America—a fall of 40 percent. In 1981 the United States had a trade surplus with Latin America of $7.5 billion. In 1983 the United States has a deficit of nearly $14 billion—for a total turnaround of over $21 billion. This deterioration is equal to roughly five times the decline in our trade balance with Japan, four times the increased trade deficit with Canada, and about two times the decline in our trade surplus with Western Europe. Because a large portion of U.S. exports to Latin America tend to be for capital goods (earth moving equipment, farm equipment, machinery) which are labor intensive industries in the United States, the jobs cost of this decline in U.S. exports to Latin America is particularly high—between 300,000 and 350,000.

Thus, even if there is a decline in the value of the dollar, the debt-related constraints on the imports of many developing countries, particularly in Latin America, will continue to result in a large U.S. trade deficit with them. There are as many proposed solution to the debt problem as there are economists or financial experts with even a passing knowledge of the issue. But the fundamental objective of most of these is to treat the debt problem in a medium-term rather than a short-term context, and to provide developing countries some relief on interest payments in the near term.

Without repeating the many complexities of the origins and current nature of the debt problem, three points are worthy of note in this context.

First, the debt problem has gone through three important stages. In 1982, there was serious concern about the threat to the international financial system posed by the high debt burden of several large developing countries; the result was a series of emergency assistance packages, beginning with Mexico in the fall of 1982.

In 1983, there was cautious optimism based on the widely held view that the threat to the financial system had been averted and that a decline in interest rates, an increase in world economic growth and developing country austerity would lead to steady, if slow, improvements. In 1984, there is a considerably more realistic attitude in most quarters, and the problem has become far more political.

This politicization of the problem is the second major point I wish to discuss with this committee. In Latin America interest payments in 1983 amounted to over $39 billion, or nearly 40 percent of the area's exports. For Argentina, Brazil, Chile and Mexico the percentages are 56, 40, 48, and 42 respectively. To increase exports and reduce imports, Latin American nations have dramatically curtailed domestic growth—down by 1.3 percent in 1982, and another 3 to 4 percent in 1983. In the words of the President of the Inter-American Development Bank, "most Latin American countries are experiencing the worst economic and financial crisis of the entire post war period."

In constricting domestic demand, developing countries are dramatically reducing imports and freeing some production for export. This, of course, reduces goods available for the domestic economy, thus adding to already intense inflationary pressures. These countries, which together have in the past been net borrowers in order to finance their development, now have interest payments which significantly exceed new external loans—forcing them into a position of making payments to banks of $7 billion more than they were lent in 1982 and $21 billion more in 1983.

Clearly some magnitude of capital outflows and trade surpluses for a period of time are necessary to reduce the debt burden. But, the greater these are in magnitude, and the longer they last, the greater the political resistance to them in these countries. The result is demands by them for greater flexibility by banks on repayment terms, and greater pressures for unilateral as opposed to negotiated solutions. Moreover, prolonged domestic austerity severely weakens the ability of leaders to govern and strengthens extremist pressures.

The third point is the difference in perceptions between the creditor banks and the borrowers. For the borrower, the cost of funds includes the interest rate (prime in the United States and LIBOR in the Euromarket) plus the "spread" and fees above it. For the banks, the spreads and fees over prime/LIBOR reflect their perception of the risk and are the basis of their profits.

Thus, both borrowers and lenders have a strong interest in a reduction in the underlying interest rate. But, if that remains high, there is bound to be pressure for lowering the spreads and fees, which borrowers regard as controllable. There is also bound to be pressure for extending the time periods over which this interest is to be paid. This is the case today, and in the recent Argentina package the costs were the lowest in any of the series of financial assistance efforts over the last two years. The Latin American governments constructive efforts to support this package were matched by a recognition of the banks that loans performing at low spreads are preferable to non-performing assets.

But all parties recognize that this is a pragmatic short-term solution to buy some time. The problem of Argentina, like that of other high-debt countries, requires a longer-term solution. The IMF just plays a central role, and thus should be able to borrow in capital markets in order to augment its liquidity. It should also be permitted to provide "enlarged access' to major countries to support their stabilization programs. The Export-Import Bank should be supported in its efforts to provide large scale guarantees for export credits to developing countries—building on the precedent of its programs for Brazil and Mexico. These should be extended to more countries and enlarged. The London Summit should aim at a decision by all major industrialized nations to institute similar programs on a large scale.

Beyond this, more structural adjustment assistance through the World Bank and the regional banks, such as the Inter-American Development Bank, will be necessary, and the U.S. will need to provide strong support to them. And commercial banks and their regulatory authorities will need to reach agreement on ways in which longer term repayments of interest by countries undertaking IMF programs can be accepted without a finding of non-performance.

Finally, there will clearly need to be some multilateral effort to improve the international trading picture. Even if thee is not sufficient time to prepare a formal Tokyo Round type of negotiation, a less formal, less legalistic type of negotiation, perhaps beginning with a few industrialized and developing nations, could be convoked to try to lower recently imposed barriers and to establish procedures for: (1) advanced notification and monitoring of government intervention, (2) ensuring that it does not shift costs to other countries, (3) ensuring that it is accompanied by internal measures which facilitate domestic adjustment so that the government intervention will be limited, and (4) obtaining timetables for a phasing down and out of such intervention. For the most part, free trade today is more a myth than a reality. While every effort should be made to resist new trade barriers, it must be recognized that governments are under pressure, to which they will often succumb, to intervene. Thus a process to minimize the length and the foreign impact of such intervention is needed. This will help the U.S. to manage its trade problems to to preserve a well functioning international trading and financial system.

Chairman GIBBONS. Thank you. And before we go to Mr. Bergsten I just want to say that during the question time I want to come back with you because of your experience in negotiation and talk more about the problem that we find ourselves in—and that is the power to do all of these things rests in the Congress, but we have not been willing to delegate anything to the Executive. About all they have got over there at the executive branch right now is freedom of speech, and for negotiation that is not much of a bargaining chip.

Mr. Bergsten.

STATEMENT OF C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. BERGSTEN. Mr. Chairman, it is a great pleasure to be back before the committee. This is a topic that we have discussed several times in the past.

I agree very much with what Bob Hormats said and I have given you a long written statement. Therefore, I will be very cryptic in my oral remarks.

Chairman GIBBONS. Do not be too cryptic. Sometimes you go so fast I have a hard time keeping up with you. You are dealing with a fellow from the South here. [Laughter.]

Mr. BERGSTEN. Well, I will go slowly but still be brief and really make only two or three major points.

The first is it is a lot worse than you think.

Chairman GIBBONS. I was worried about that. I think it is, too.

Mr. BERGSTEN. You will recall that I testified before this committee back in 1981 and told you that the trade deficit was going to $100 billion.

Chairman GIBBONS. And I did not believe you.

Mr. BERGSTEN. You did not believe me and nobody believed me, but I was right. Now I tell you—and I testified back in November—that the trade deficit here in 1984 will hit $120 billion. As Bob said, it has already come in at an annual rate of $105 billion in the first couple of months. It is going to hit at least $120 billion; even I may have been too low this year.

But what is even more important is to go forward in time. It is not just 1984 that counts. What is the trend? I would project it out to about $150 billion in 1985, with no sign of a turnaround. To me that is the crucial thing and frankly what you ought to be asking the administration. If one could persuasively argue that this is a temporary problem, which is about to turn around and at least head in the right direction, that would be very different from the way I see it.

The dollar stays at incredibly overvalued levels. U.S. growth, for which we are happy, is more rapid than that of other countries, but that makes our trade deficit deteriorate further. There is simply no reason, despite the statements to the contrary by some in the administration, to believe that the huge deficits are going to be reduced even modestly later this year or in 1985 or in any year beyond that I can see, barring a sharp recession in this country, which would cut the demand for everything here and take import demand down along with it.

So the first point really is that it is very bad and getting worse and no sign at this point of any turnaround in the deterioration, let alone getting back down to levels that any of us would regard as tolerable and sustainable over the longer run.

The second point is to draw out some of the consequences which you will face here, I think, increasingly in terms of proposals to respond to this by import controls, export subsidies, surcharges, whatever it may be, because if I am right that the situation is going to get worse, the pressure on you is going to get greater.

Some of the implications go beyond just the level of unemployment that is created, as bad as that is. I think we are now seeing an increasing questioning by U.S. firms as to whether they really ought to invest in the United States, given the competitive disadvantages they face with the dollar at these levels and possibly staying at these levels.

They hear Marty Feldstein, for whom I have great praise on most things, saying as long as we have huge budget deficits we are going to have an overvalued dollar and huge trade deficits. Well, since we all know we are going to continue to have huge budget deficits, whatever you all do, for at least many years to come, that says to a Lee Morgan at Caterpillar or his corporate colleagues that maybe we are going to have an overvalued dollar and a massive price disadvantage for years to come.

Therefore, why should I put up a plant in the United States? Lee Morgan, in his testimony to you this morning—I did not hear the discourse but I quickly read his statement—noted that they had simply had to move a lot of their sourcing offshore. There is public testimony from Ingersoll-Rand and many companies that they have had to shift very sharply their servicing of world demand to non-U.S. subsidiaries that they already have. That is, of course, a big factor in the loss of jobs.

But then as the economy here picks up and hopefully the world economy picks up, soon arises the next question: When I decide to put up new plant and increase my capacity, where do I put it? Can I really put it here in the United States if I fear that I am going to be 25 percent overpriced vis-a-vis my main competitors for some indefinite period of time in the future?

I am afraid firms will increasingly answer that question in the negative. That is what happened when the dollar was so massively overvalued in the late 1960's and early 1970's. That is when we saw the big wave of U.S. foreign direct investment around the world, and I think to the extent we have got any risk of deindustrialization in this country that is it, not the things that are sometimes spoken of under the rubric of industrial policy.

Rather, if by our own hand we price ourselves out of world markets, it is very hard to imagine our internationally competing firms, whether exporters like Caterpillar or import competers, are going to put their new plant and equipment here, or not increase further their offshore sourcing, as the auto industry, among others, has done.

So it seems to me there is a long-run implication here. Economists and businessmen alike have tended to assume that under flexible exchange rates there may be a disequilibrium in the short run but it will even out over time. Well, some of us were premature, myself included, in predicting that would happen. It has not happened yet. It may happen in the future. It may not happen very fast, either.

And, as Bob said, even if you correct the budget deficit the short-run impact might even be to strengthen the dollar because people around the world would say there is surely only one thing wrong with the American economy. It is the budget deficit. If you put that in shape, they will say now the U.S. economy has everything going for it so let's put our money in the dollar even if interest rates come off, as Bob suggested.

So there is a long-run problem here that goes beyond the immediate, which I think intensifies the difficulty and adds to the problem.

The final point I would make demonstrates how dramatic this swing is. That is the deterioration of the net international investment position of the United States, which we have talked about this before. For 65 years, 1917 through 1982, the United States built up a huge creditor position around the world. Our assets exceeded our liabilities by almost $200 billion and on that we earned handsome income every year—$30 to $35 billion—which augmented our welfare, our income, our gross national product.

Now in 3 years the 65-year buildup will be thrown away, indeed reversed, and on my projections by about 1986 the United States will be a net debtor country about on the order of Mexico and Brazil today, that is, about $100 billion. Since I see no improvement coming, those numbers continue to grow and one could easily envisage, as a couple of projections have, the United States being a net debtor country abroad, by the end of this decade, to the tune of half a trillion dollars.

Now I would hope that there is an adjustment that takes place before that, but in the absence of an adjustment that is what is going to happen if we continue to require capital inflow of $100 billion a year to finance the trade and current account deficit. That adds, dollar-for-dollar, to our net foreign debt which we have to service.

In some sense it is the international counterpart of the domestic budget deficit. You know those figures better than I. The domestic debt is doubling in just 5 years where it had built to in the whole history of the republic before. This is the international equivalent. The 65-year buildup of net assets has been dissipated in 3 and will turn into a massive debtor position in another 3 or 4.

Chairman GIBBONS. It is like the fellow that gets cancer at 65 or before he gets medicare.

Mr. BERGSTEN. There are very pragmatic results. It is not just that we are draining resources from the rest of the world and distorting international investment and all of that. It is that we have to pay the debt and we have to pay it to those offshore, and all things equal that means we need a better trade surplus to get into equilibrium. It means a lower income for the United States. Over time, it means a lower dollar and all of that.

Finally, what to do about it. As I have already suggested in this long parenthesis about the budget, I support every effort possible to get the deficit down, but, as Bob Hormats was saying, that may not be a panacea. That is a tough one.

It seems to me in a sense the debate is a bit ill organized. The tendency is to ask what causes the overvalued dollar and therefore what we should do about it. Those are two separate things. What causes the strong dollar in part may be not susceptible at all to policy response.

For example, the safe haven appeal of the dollar clearly is one factor keeping it strong. One of us would sit here and say we want to turn the United States into a weak country that nobody admires or is interested in investing in, in order to get the dollar down. That would be crazy. We could not do it if we wanted, and none of us are going to do it. We want to maintain the United States as a safe haven.

So that cause of the strong dollar is not something that points to a policy response. What we have to ask ourselves, I think, is what policy measures are feasible that would offer some reasonable promise of correcting the exchange rate disequilibrium, and here it seems to me there are several things to do, some shorter run, some longer run.

A lot of this is psychology in the exchange markets. We know that. We know that with a fairly unchanged set of underlying economic fundamentals, the dollar moved from 2.50 deutsche marks at the end of last year to 2.85 deutsche marks in February and now back to about 2.60 Deutsche marks—a 10 to 15 percent swing with no substantial change in the underlying economics or fundamental issues.

There were changes in perceptions. But what that says is that there is a lot of psychology in the market. Therefore, very short-run things could have been done which might have had a dramatic impact—as I mentioned to the committee before in the context of dollar/yen movements.

When the market begins to take the exchange rate in the right direction, the authorities working jointly should come into the market, move with the trend and try to promote its moving further and faster in order to move toward what we all think some sort of an underlying equilibrium would call for. I think that is eminently feasible. It has been rejected by the current authorities. I think they should reconsider that policy.

I would call it an intervention policy of leaning with the wind when the wind is blowing in the right direction of underlying equilibrium, rather than the traditional approach of leaning against the wind, whose only goal is to minimize short-run volatility in the exchange markets. Short-run volatility in the exchange markets is a nuisance to traders but it does not have much economic effect. It is not worth spending a lot of resources to counter, except when it is really undermining confidence in your overall economic policy.

So what you should do with intervention is try to use it to achieve underlying equilibrium when the market is moving with you and you can play on it. That is one step.

Second, to return to the more fundamental issue, is the budget deficit. I think that over time, if significant action is taken to get the budget deficit down and decisively so and on a credible, lasting basis, it will bring our interest rates down both directly and because it will permit the Federal Reserve to run a more accommodative monetary policy.

So whereas in the short run it would seem to have the U.S. dealing with its one significant outstanding problem, over the slightly longer run I think it still would be critically important as a move to help deal with the international problem as well as the domestic problem.

But, and here I would close with what Bob also said: It may be that will not be enough or it may not happen very soon. It depends largely on other countries. As long as there is no buoyancy of optimism about Germany, even Japan, the Deutsche mark and the yen do not have the same appeal that they did a few years ago, and that means that though one does not care for it one may have to look to what economists call second best solutions.

If you get your fundamentals right, you may still have to look at dealing directly with the capital flows which, as Bob pointed out, overwhelm the underlying fundamentals at the moment.

I have suggested several things. One would be for the other countries, Europe and Japan, to consider putting on limitations on the capital outflow which is feeding the strength of the dollar and undermining their own currencies. It is interesting to note that the United States did exactly that in the 1960's when we had the same problem.

In the 1960's, the United States had a trade and current account surplus like Europe and Japan do today. However, we had a much bigger capital outflow that swamped our trade surplus, like Europe and Japan do today. That was largely due to the fact that then U.S. interest rates were low and foreign interest rates were high, the opposite of today.

And so the United States, despite its own ideological preference for free markets and all of that, did intervene directly in the capital markets by applying an interest equalization test to try to equalize at the border these huge interest rate differentials that motivated such huge capital flows and distorted currency relationships.

The U.S. interest equalization tax worked, by most analyses, for a couple of years. It was then largely gutted by exceptions both for types of flows and for geographic regions, and it really wasn't carried out in a very wholehearted way. But it does show what can be done.

Now, today, if Europe and Japan were to take that path, they would face a world which is much more integrated in terms of capital flows and therefore has more room for leakage. On the other hand, since the flows are much bigger, the impact of measures of that type at the margin would also be, I think, very powerful.

And since it is what happens at the margin that counts, not whether the level of flow is $100 or $700 billion—what you want to affect is what happens at the margin—you might be able to do that very substantially and thereby have a big impact on exchange rates, get the bandwagon rolling in the right direction, come in with joint intervention and push the rates in the correct direction.

The Japanese, to whom there has been a lot of attention this morning because the yen rate is so important for competitive reasons and trade policy, could do it much more simply. They could carry out what I call the 30-phone-call approach, where the finance ministry by all accounts still has the clout to get on the phone to the big banks, insurance companies, and pension funds and tell them to limit the capital outflow for a few quarters.

After the second oil shock in 1980, they made the 30 phone calls because they were running huge current account deficits. Lo and behold, the capital outflow ceased for almost a year.

It is a bit harder at this time, given the fact that the interest rate differentials still tend to motivate capital flow out of Japan and into the dollar, but I still have sufficient confidence in the authorities in Japan to believe that with an effort they could move to have quite an impact on the dollar-yen rate directly.

You will note that when I say that I find myself regretfully in the position of arguing contrary to what Lee Morgan was arguing this morning. As a long-run proposition, I think it is quite right to go after liberalization of the Japanese capital markets and even perhaps internationalization of the yen.

I must say, however, I do not think one can count on either of those moves as doing very much to help the exchange rate disequilibrium either in the short run or in the long run. So, though I regret it in terms of my own belief in market orientation and the like, I am compelled by my concern about the depth of the problem and my lack of optimism that other steps are going to be taken, to suggest that one might have to deviate from those druthers in the short run and actually manipulate the capital flows in the direction of exchange rate equilibrium, and hope that over time we could get the fundamentals in place so that would not be necessary on a lasting basis.

[The prepared statement follows:]

STATEMENT OF C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS

THE U.S. TRADE DEFICIT: CAUSES, CONSEQUENCES AND POLICY RESPONSES

Summary

The outlook for the international trade (and financial) position of the United States is shocking:

In 1984, the merchandise trade deficit will probably hit $120 billion and the current account deficit could approach $100 billion. The trade deficit during January-February has already soared to an annual rate of $105 billion, and is rising at a dramatic pace.

In 1985, the trade deficit could reach $150 billion and the current account deficit about $125 billion.

As many as three million Americans will be unemployed by late 1985 as a result of this deterioration in our external accounts.

Moreover, the specter of continuing massive trade deficits (and the dollar overvaluation which largely spawns them) is inducing major U.S. firms to contemplate investment abroad rather than at home, as occurred during the last major period of dollar overvaluation (late 1960s—early 1970s), with the attendant risk of substantial deindustrialization of our economy.

In addition, as a result of the huge net capital inflows needed to finance these deficits, the United States by 1986 will clearly owe more to foreign nations than the value of its own investments abroad—becoming a net debtor nation for the first time since World War I, and probably approaching the present debt level of Mexico and Brazil in absolute terms.

This reversal of America's international investment position will eliminate much or all of the annual net inflow of investment income to the United States, which peaked at over $33 billion in 1981 and has been a major source of strength of our current account for decades—which, in turn, will require an even greater improvement in the merchandise trade balance to restore current account equilibrium.

These problems can be resolved only through correction of the massive overvaluation of the dollar, now on the order of 20–25 percent. In addition to causing most of the huge trade deficits, continued dollar overvaluation is a major source of pressure for trade protection measures and (as noted above) is forcing major American firms to contemplate investing abroad rather than domestically.

To help correct the currency misalignment, the monetary authorities of the United States and other major countries should have intervened jointly in the exchange markets in recent weeks to sustain and accelerate the strengthening of the yen and European currencies that occurred during February and early March, as they should have during the similar corrective movements of late 1982 and fall 1983 which stalled out and subsequently were reversed. In such circumstances, the authorities should replace the traditional intervention criterion of "leaning against the wind" to "lean with the wind" when it is blowing in the direction of underlying equilibrium.

To assure lasting and stable dollar correction, however, urgent action is needed to substantially reduce the budget deficit and thus U.S. interest rates—which draw large amounts of capital into the dollar. (It must be recognized, however, that the short-run impact of budget action might be to strengthen the dollar, and that failure to deal decisively with the budget might lead to an unstable, i.e., precipitate and excessive, fall in the currency.)

In the absence of such steps, and perhaps even in addition, direct action to alter international capital flows may be needed. As other nations share the U.S. interest in correcting the currency misalignment, the most feasible remedy is probably for the major capital-exporting countries (Japan and Europe as a group) to install interest equalization taxes or limit their outflows temporarily through direct controls.

It would be a mistake to apply an import surcharge as a corrective device, as envisaged in Section 122 of the Trade Act of 1974. Under floating exchange rates, such a step could be expected to lead to a further strengthening of the dollar—which would offset the gains from the surchage, in large part by driving U.S. exports down even further—in reponse to market expectations of those gains. In addition, any such act by the United States—the only industrial country in the world which has recoverd rapidly from the recession and where unemployment is falling sharply—would clearly trigger major retaliation from abroad, perhaps destroying the relatively open trading system and detonating the "debt bomb' by denying the expanded export opportunities which are the only means by which many developing countries can hope to keep servicing their external liabilities.

The trade outlook for 1984

The U.S. merchandise trade deficit reached an annual rate of about $75 billion in the fourth quarter of 1983. For the year 1983 as a whole, the deterioration in real net exports of goods and services retarded the recovery by a full 25 percent—bringing it in at 3.3 percent rather than the 4.4 percent (year-over-year) which would have occurred with an unchanged trade balance. In 1981–82, of course, the deterioration in real net exports accounted for fully 75 percent of the total decline in the economy and was by far the biggest cause of the recession.

In 1984, substantial continued deterioration is certain. First, the dollar has until recently continued to reach new highs in the exchange markets and is now overvalued—relative to underlying competitive positions—by 20 to 25 percent.[1] This is the equivalent of placing a 20 to 25 percent tax on all U.S. exports and paying a subsidy of 20 to 25 percent on all imports coming into the United States. Every percentage point deterioration in U.S. price competitiveness costs our trade balance $2 to $3 billion over the coming 1 to 2 years. Hence about $10 to $15 billion of additional loss will stem from the further dollar strength of late 1983, unless it is quickly and permanently reversed.

Second, the United States seems likely to continue growing faster than all other major countries in 1984 (for an unprecedented second straight year). DRI projects the United States at 5.3 percent and the rest of the world at about 3.5 percent, while Project LINK has the United States at 5.6 percent and the rest of the OECD at about 2.5 percent. This means that U.S. demand for imports will be growing much faster than foreign demand for U.S. exports.

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[1] For the methodology and detailed calculations, see John Williamson, "The Exchange Rate System" (Washington: Institute for International Economics, September 1983).

In addition, the U.S. income elasticity of demand for imports is substantially higher than that abroad. U.S. imports now tend to grow about 50 percent faster, compared with our GNP growth, as do imports abroad. So the continuing "growth gap" will add at least $20 billion more to our trade balance deterioration.

Three other factors could affect the outlook. There should be a modest pickup in the imports of some debt-ridden developing countries, such as Mexico, which will help U.S. exports. Our terms of trade could continue to improve, as happened—due mainly to the strong dollar itself—throughout 1981-83 (masking much of the deterioration in our real trade balance). But the long-anticipated fall in the dollar, if it materializes in 1984, could have the opposite effect instead; even a 10 percent fall in the dollar could, in the first instance, add as much as $10-15 billion to the trade deficit.[2]

The most likely outcome for 1984 is thus a merchandise deficit of about $120 billion—a bit larger than the $110 billion forecast in the recent "Annual Report of the Council of Economic Advisers" (page 43).[3] The January and February deficit has already come in at an annual rate of $105 billion with imports valued on an f.o.b. basis.

This trade outcome will in turn take the current account deficit to about $100 billion. The surplus on services and unilateral transfers, which climbed as high as $33 billion in 1981, is declining sharply primarily because of our interest payments on the massive buildup of foreign investments here which are financing the current account deficit. This surplus fell to about $20 billion in 1983. It could well dip even lower in 1984, even taking into account some increase in our direct investment earnings because of a pickup in economies abroad.

It is particularly tricky to try to convert these trade numbers into their GNP equivalents, but an outcome as described could take 1½-2 percentage points off economic growth in 1984. The deterioration of about $100 billion from 1981 to 1984 means that by the end of this year there will be about 2½ million unemployed workers—about three-quarters of them in manufacturing.[4]

Further deterioration in 1985

Contrary to the assertions of some Administration officials, and the views of some forecasters, the trade deterioration is virtually certain to continue at least into 1985. The pace of the deterioration, however, barring a further sharp rise in the dollar this year, is unlikely to be as great as in 1981-84.

The same factors as in 1984 suggest this outcome. The trade impact of the late-1983 rise in the dollar will continue into 1985, in view of the time lags involved, unless quickly reversed. Moreover, the "growth gap" is unlikely to be reversed—DRI sees U.S. growth at about 3½ percent compared with 3 percent or less for the rest of the world, while Project LINK sees both the United States and the rest ot the OECD slightly above 3 percent. By then, a lower dollar is very likely—with adverse J-curve effects for a while.

Quantitative forecasts are obviously less certain as the forecast period recedes into the future, but the merchandise deficit could easily approach $150 billion in 1985. The current account deficit would then be at least $125 billion. Enough additional job loss would occur to take the cumulative total, from 1981, to beyond three million.

The situation beyond 1985 will depend on the further course of the two variables emphasized: (1) if, when and by how much the currency misalignment is corrected, and (2) if, when and by how much the "growth gap" between the United States and other major countries is narrowed or reversed. Recall, however, that our real net exports deteriorated sharply throughout the recession of 1981-82—in fact, equalling about 75 percent of the total fall in real GNP. Hence the inevitable slowdown in U.S. expansion need not, by itself and without the needed exchange-rate realignment, improve the trade balance to any significant extent. DRI has forecast a continuing deterioration of the U.S. current account, albeit at lower levels than my own forecasts, through 1986 despite a decline in U.S. growth below that of the other industrial countries in that year.[5]

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[2] As a result of familiar J-curve effects, assuming a 50 percent price passthrough.

[3] And hitting the 12-digit level which, I believe alone, I began forecasting in late 1981 and throughout 1982. See my "The Costs of Reaganomics," *Foreign Policy* (Fall 1981) pp. 28-29, and "The International Implications of Reaganomics," Kieler Vorträge, no. 96, February 18, 1982. Both are reprinted in the "The United States in the World Economy: Selected Papers of C. Fred Bergsten 1981-1982," Lexington, Mass.: D.C. Heath and Co., 1983.

[4] Data Resources, Inc., "The DRI Report on U.S. Manufacturing Industries" (January 1984), p. 65.

Deindustrialization

Beyond the trade deficits themselves, dollar overvaluation poses a growing threat to future investment in U.S. plant and equipment. A large segment of American industry, running as high as 60–70 percent on some estimates, must now compete actively with firms based abroad either in world markets or here at home. Yet many of these firms are increasingly aware that the huge price disadvantage caused by dollar overvaluation may persist well into the future, if no action is taken to deal with the underlying cause of the problem—the budget deficit.

Some firms are therefore beginning to question the wisdom of future investment in the United States. Continued sizable dollar overvaluation would be likely to force them to invest abroad instead, not from any "runaway plant" mentality but simply for self-preservation, particularly because their foreign competitors are enjoying such huge profits and may be reaping irreversible competitive gains. Indeed, massive foreign direct investment was one result of the last prolonged period of dollar overvaluation in the late 1960s and early 1970s.[6] Such a shift would of course further reduce job opportunities in the United States. In addition to jeopardizing the sustainability of the present recovery, this phenomenon is probably the greatest present cause for concern over any future "deindustrialization" of our economy.

Protectionism

The history of U.S. trade policy throughout the postwar period reveals that dollar overvaluation, even more than aggregate unemployment, is the most reliable "leading indicator" of protectionist trade pressure in this country.[7] The reason is clear: dollar overvaluation badly jeopardizes the competitive position of even our healthy import-competing industries, as well as those which are traditionally vulnerable. Hence the coalition which seeks import relief is broadened substantially. The latest evidence is the adoption by the current Administration, despite its philosophical devotion to open markets and free trade, of major protectionist steps in at least a half dozen industries to date (autos, textiles/apparel, steel, sugar, motorcycles, and specialty steel). Indeed, major new trade controls were adopted in 1983 despite the substantial decline in the aggregate rate of unemployment.

These pressures could become particularly intense in 1984 and 1985. As noted, the trade deficit will soar to $100–150 billion. Unemployment, though down sharply, will still be high—a great deal of it directly traceable to trade—and could begin rising again within the next 12 to 18 months. The election campaign will generate intense pressures to support additional import relief.

Continued dollar overvaluation would undermine the traditional case for open trade, in part because the benefits of such trade would be skewed heavily against the United States. Indeed, Section 122 of the Trade Act of 1974 authorizes use of an import surcharge "to deal with large and serious United States balance of payments deficits."

Under flexible exchange rates, however, an import surcharge could well be ineffective or even counterproductive. As soon as it was implemented, the markets would expect a consequent improvement in the U.S. trade balance. As a result, the exchange rate of the dollar could be expected to strengthen. (Evidence for this effect is provided by the episodic weakening of the yen over the past few years on news concerning possible new controls, in Europe as well as the United States, against Japanese exports.) Indeed, theory would suggest that the further overvaluation of our currency would fully offset the impact of the additional tariff.[8] Without necessarily trying to be so precise, it seems likely that our overall trade balance would gain little if any from an import surcharge offset by induced dollar appreciation—as exporters were hurt substantially and import-competing firms and workers were helped much less net than gross.

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[5] Data Resources, *U.S. Review* (January 1984), table 7.4.

[6] There were of course other major reasons for the expansion of foreign direct investment by U.S.-based firms during that period. However, the buildup correlates almost precisely with the growing dollar overvaluation and, given the inherent lags in corporate planning, so did its slowdown from the mid-1970s (after the dollar devaluations of 1971–73). Likewise, investment in the United States by foreign-based firms was small prior to those currency corrections but has expanded rapidly since then.

[7] C. Fred Bergsten and John Williamson, "Exchange Rates and Trade Policy," in William R. Cline, editor, *Trade Policy in the 1980s*, Washington: Institute for International Economics, November 1983.

[8] B. J. Eichengreen, "A Dynamic Model of Tariffs, Output and Employment Under Flexible Exchange Rates," *Journal of International Economics*, August 1981. In fact, Eichengreen concludes that increasing tariffs under flexible exchange rates, while it might create a modest number of jobs in the short run, would over time be likely to have a negative net impact on the level of employment.

Moreover, any adoption of such a major protectionist device by the United States at this time could topple the open trading system which has been so crucial to postwar prosperity. Europe, with its much higher level of unemployment and structural economic woes, would almost certainly reply in kind (or worse). The developing countries, seeing the evaporation of their only hope to earn their way out of the debt crisis, would tighten their own trade controls further (and might even be pushed over the brink to massive moratoria and/or defaults). The damage to the world economy, from adoption of a major restrictive step by the only industrial country which is enjoying substantial recovery and declining unemployment, would be all too reminiscent of the 1930s and could take years (or decades) to repair.

A "stabilization crisis"

One other possibility, recently outlined by my colleague Stephen Marris, is that the trade deficit itself, along with a failure to deal with the budget deficits and fears of renewed inflation, will produce such a precipitous fall in the exchange rate of the dollar as to have major adverse consequences for our economy.[9] Such a fall would come from a sharp reversal in capital flows, stemming from a collapse of international confidence in the sustainability of the American situation, which would then push US interest rates up both directly and—because the Federal Reserve might have to tighten money to stem the run on the dollar—indirectly.

Moreover, a sharp decline in the dollar would add significantly to inflationary pressures in the economy: a fall of 25 percent in the exchange rate would add three to four percentage points to the price level.[10] As a result, the United States would for a while get the worst of all worlds from its external accounts: a continued huge trade deficit, because of previous dollar overvaluation, and then higher interest rates and new inflationary pressures as well from a rapid fall of the currency. Again, urgent action is required—to begin the adjustment process soon enough, primarily through action on the budget deficit, to foster the needed currency correction in a relatively smooth manner, without a "free fall" a la 1978 and the enhanced risk of overshooting to an excessively weak (and inflationary) dollar once again.

The United States as a debtor country

One well-known component of this scenario is a huge net inflow of capital into the United States to finance the current account deficits. It is not widely recognized, however, that the magnitude of this flow seems certain to convert the United States in only 3 years into a debtor nation—for the first time since World War I, reversing the 65-year buildup of our position as an international creditor country.

The cumulative current account deficits for 1983–85, as projected here, exceed $250 billion. At the end of 1982, the net US creditor position was only $168 billion. Hence that position could be virtually wiped out by the end of this year, and seems certain to disappear during 1985.[11]

Two statistical caveats are worth noting. On the one hand, U.S. assets abroad consist much more heavily of direct investment ($221 billion, end-1982) than do foreign assets here ($102 billion). Since direct investment is calculated at book rather than market value, and since the stock of U.S. direct investment abroad is considerably older on average than the stock of foreign direct investment here, our net creditor position on that account is probably understated.

On the other hand, the extent of foreign capital flow to the United States in recent years has almost certainly been significantly understated. During 1978–82, the U.S. accounts include an unrecorded inflow ("statistical discrepancy" or "errors and omissions") which cumulates to over $130 billion. Some of this could be unrecorded exports of services, but "the discrepancy was probably in large part accounted for by unrecorded capital inflows."[12] Hence, if anything, the official data today probably overstate rather than understate the U.S. international creditor position—reducing the base from which its reversal is now underway.[13]

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[9] Stephen Marris, "Crisis Ahead for the Dollar," *Fortune*, December 26, 1983.

[10] The correction in the exchange rate of the dollar which is needed, as noted above, would of course also produce such an effect—but in a more orderly way over a longer period of time. Indeed, the inevitable upward push in the CPI from dollar depreciation—which, it should be noted, does not affect the "core" or "underlying" inflation rate—is better taken now than later, given the continuing low level of recorded inflation, thus adding to the urgency of restoring dollar equilibrium.

[11] The lates annual report of the Council of Economic Advisers, p. 57, agrees that the United States will probably move into net debtor status "sometime in 1985." Paul Volcker has testified to the same point on several recent occasions.

Thus the United States seems destined, in the course of only three years, to offset the buildup of net assets abroad which began during World War I. We would thereby return to our 19th-century status as a debtor nation, when we were a developing country.[14] Indeed, the magnitudes indicated by this analysis suggest that the United States could be challenging Brazil and Mexico for ranking as the top debtor nation in the world by 1986.[15]

There are numerous implications which stem from this prospective shift of the richest country in the world to debtor status. One is the huge misallocation of world resources which is suggested. Another is increased vulnerability for the dollar; my earlier studies show that the dollar crises of the 1960s and early 1970s were all associated with a decline of key U.S. "liquidity ratios"—the relationship between our reserve assets and foreign dollar holdings, on various definitions[16]—below 100 percent, and a shift to net debtor status could be expected to have at least as much impact.

One very practical effect of this shift is that the U.S. current account will no longer benefit from net earnings on foreign investment—because the foreign investment account will be in deficit rather than surplus. Our net investment income peaked at over $33 billion in 1981, but has already dropped by $6 billion in 1982 and another $4 billion in 1983. As we service the huge buildup of foreign holdings here, the remaining surplus will decline precipitously and perhaps disappear by 1986—even taking account of the higher return on U.S. assets abroad because of direct investment's greater share in them.

This in turn means that the United States will no longer be able to offset, via a services surplus, a merchandise trade deficit of $25-30 billion. Hence the required improvement in the trade balance, from the massive level of deficit to which it is now soaring, is even greater than it would have been in the early 1980s to achieve equilibrium in the overall current account.

What to do

Even if one were to quarrel with the precise magnitude of these estimates, it is hard to escape the overall conclusion: that the United States is now experiencing a massive, historically unprecedented erosion of its international trade and financial position. Moreover, given the time lags involved and policies now in place, it is too late to change the picture much for 1984 and it is getting late to do so for 1985. Nevertheless, the outlook is so dire—and the likelihood so uncertain of achieving the needed correction in a healthy manner, if at all, under present policies—that the case for early action seems compelling.

Of course, the dollar recently declined a bit in the exchange markets and, as noted above, could fall rapidly as a result of the U.S. trade and current account deficits themselves, along with continued failure to resolve the budget problem. U.S. capital outflows, which fell sharply in 1983, may accelerate again as economic recovery picks up abroad. A renewed outbreak of inflationary expectations here could—most unfortunately, in this instance—promote correction of the dollar, as could the

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[12] *Survey of Current Business*, August 1983, p. 43, in explaining the anomalous further rise in the U.S. international creditor position in 1982 despite a current account deficit of $11 billion. No such anomaly is conceivable in 1983-85, however, because of the much larger magnitude of the current account deficit. Moreover, the "statistical discrepancy" seems to have disappeared in 1983.

[13] A third caveat is that valuation adjustments, such as the recent sharp rise in value of U.S. stocks and bonds, also affect the international balance sheet of the United States in ways not related directly to the current account position.

[14] The United States was still a net debtor, to the tune of $3.7 billion, in 1914 but had moved to creditor status of a similar magnitude by 1919. See Hal B. Lary, "The United States in the World Economy," Department of Commerce, 1943, pp. 122-24.

[15] Net external debt of both Brazil and Mexico will probably approximate $100 billion in 1986, as would that of the United States with the level of current account deficits suggested here. However, the debt-to-export ratio of the United States, at about 40 percent, would be much more like that of Hungary, Romania and Thailand than Brazil and Mexico (over 200 percent even after substantial improvement by 1986). For the LDC numbers see William R. Cline, "International Debt and the Stability of the World Economy" (Institute for International Economics, Sept. 1983), pp. 54-55, 132.

[16] C. Fred Bergsten, "The Dilemmas of the Dollar: The Economics and Politics of U.S. International Monetary Policy" (New York: New York University Press, for the Council on Foreign Relations, 1975), esp. pp. 148-152.

(also unfortunate) adoption of new stabilization measures (including higher interest rates) by other key currency countries.

None of these developments can be accorded a high probability, however, and the last mentioned—dollar correction via renewed inflation expectations—would raise major problems of its own. Moreover, as emphasized throughout these remarks, the situation is getting steadily worse. Decisive action to reduce the budget deficits (and hence interest rates) thus remains the most critically needed step to resolve our external problems (as well as central internal problems). Failing such action, however, it may be necessary to adopt "second best" measures aimed directly at the proximate source of the problem: the capital flows which are swamping the trade and current account balances and prompting exchange-rate relationships which are so at variance with underlying competitive realities.

In this context, there was a recent opportunity to improve the situation. During February and early March, the DM (and other European currencies) moved up sharply against the dollar. The yen joined the move in early March as well. As in two earlier cases then the yen moved up strongly (late 1982 and fall 1983), serious joint intervention by the United States and the countries whose currencies were rising—building on the market swing—could have intensified its speed and extent and perhaps assured that it would, at last, represent the permanent turning of the tide that is needed. The central banks would obviously have to be careful that they did not trigger an excessive ("bandwagon") move, and be ready to change course if that seemed to be occurring, but the failure to act in the face of excessive dollar strength over the past three years has clearly been a mistake.

Since no action was taken, however, the reversal once again appears to have stalled out or reversed itself, representing merely another false start with no lasting impact. The need here is to reverse the existing thrust of intervention policy: to "lean with the wind" when it is blowing toward underlying equilibrium, rather than always "leaning against the wind" to smooth short-run market turbulence (or abstaining from engagement altogether).

In considering how to manipulate capital flows on a more lasting basis, if that turns out to be necessary, it is important to recognize that many other nations are also being hurt by the nexus of high U.S. interest rates and dollar overvaluation. To be sure, their trade balances gain as the United States suffers the massive trade deterioration just described. But this effect, for most countries, is probably more than offset by the depressing effect of high U.S. interest rates on domestic demand within their borders.

In fact, most other countries cannot now use monetary policy to promote economic recovery. For example, Germany raised its key interest rate in September 1983 despite the very modest growth of its economy. Japan, to avoid further weakening of the yen and intensified protectionist reactions, has for over two years kept its interest rates at least two percentage points higher than called for by domestic conditions. Most of these same countries are determined to tighten their budgetary policies, for long-run reasons of fiscal prudence and judgments concerning more immediate confidence and supply-side effects. The result is that most major countries—including Japan, Germany and the United Kingdom—have no policy tools available to promote more rapid rates of expansion.

In addition, all countries suffer from the intensification of the global debt crisis caused by dollar overvaluation and high U.S. interest rates. And the protectionist pressures which are greatly intensified in the United States by dollar overvaluation, and threaten to block some of the export expansion which others could enjoy due to their currency undervaluations, are also a major source of concern abroad.

All countries thus have a major interest in launching steps to correct the situation. This interest has recently been manifest in the calls of the French Minister of Economy, Finance and Budget, the architect of his country's quite orthodox austerity program, and the Social Democratic Party in Germany, for Europe to seek ways to "decouple" from the dollar.

One way to do so would be for the European countries (perhaps as a group) and Japan to crack down on their capital outflows.[17] For example, they could install an Interest Equalization Tax (IET), as the United States did in 1963 when faced by similar circumstances: a current account surplus more than offset by capital outflow due largely to higher interest rates abroad. The U.S. IET only worked for a couple of years, although it stayed on the books until 1974, but it exempted much of the capital account and a good part of the world so is not a very precise model for similar action today.

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[17] In principle, the United States could also try to limit capital inflow, as Germany and Switzerland did in the late 1960s and early 1970s. However, the vast size of the U.S. capital market and the widespread international use of the dollar, along with the fact that it is always easier to control your own residents than non-residents, suggests greater effectiveness of actions initiated by the other countries (but, as noted below, fully supported by the United States).

A contemporary effort by Europe and Japan would have to be quite comprehensive in scope, except perhaps for bona fide export finance and credits to debtor developing countries, and applied much more vigorously. Given the magnitude of today's capital markets, there would still be considerable leakage. But many billions of dollars of capital outflow could presumably be checked rather quickly, turning the tide in the exchange markets.

Those who recall the relatively modest (and short-lived) results in the U.S. capital restraints of the 1960s also ignore one vital difference between then and now. If Europe and Japan took such action today, they would be moving toward underlying equilibrium whereas the United States was trying to shore up a currency which turned out to be substantially overvalued. Thus a European-Japanese IET would be moving with, not against, underlying market forces and should have a good chance of working. The key is to achieve a convincing shift in short-run market trends, which could be done by offsetting the interest-rate advantage that temporarily props the dollar without permanently distorting the international capital markets.

Alternatively, the Europeans and Japanese could simply shut down most capital exports for a while through quantitative controls. Japan, in particular, could use administrative guidance to check temporarily the massive foreign investments of its insurance companies, banks and other large institutional investors.[18] The techniques involved should be determined by each country, but implemented jointly and quickly to have the desired psychological as well as real effect on the exchange markets.

Once the tides were turned, and the correction was underway, joint intervention in the exchange markets by the U.S. and foreign authorities could accelerate its pace and extent. In addition to joining the intervention effort once the market trends were turned, the United States would of course have to endorse fully the actions of the capital-exporting countries (to obviate any fears that their actions were taken "against the United States").

To be sure, steps aimed at direct manipulation of capital flows (or exchange rates themselves) are decidedly inferior to dealing with the fundamentals of the situation: primarily the huge ongoing budget deficits in the United States and the resulting high real interest rates which support the dollar at overvalued levels. Action on these basics must, and surely will, eventually occur. But the uncertain outlook for their early resolution and the costs of inaction—as detailed above—are extremely high and growing steadily worse. It is thus critically important that this committee, and the rest of the Congress, succeed in the current effort to move decisively to enact substantial, lasting, and credible reductions in the budget deficits—for external as well as internal reasons.

Chairman GIBBONS. I want to thank both of you for excellent discussions. And Dr. Hormats, it seemed like you had something you wanted to say, perhaps, after Fred had talked there?

Mr. HORMATS. No; I guess I very much share his pessimism that the equilibrating mechanism is going to work. We may or may not agree on the question of capital controls, and there are ways of doing it that would be less damaging than others, and it is a second best solution, as Fred has pointed out.

But I am very worried that we have not really focused as a country on the drastic implications of the sorts of numbers that we are talking about in terms of the future in terms of the trade deficit. What we are doing, we are running our budget on borrowed time and borrowed money, and we are going to either suffer a major further deterioration in a lot of sectors of the American economy or we are going to have to find some way of moving toward equilibrium.

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[18] As they are reportedly already doing to some extent. It should be noted, however, that the thrust of the Reagan-Nakasone agreement of November 1983 was for Japan to open its capital markets further—which could well promote more capital outflow and thus again weaken the yen. For recommendations on the yen see C. Fred Bergsten, "What To Do About the U.S.-Japan Economic Conflict," *Foreign Affairs*, Summer 1982.

And I do not think there has really been a major policy debate yet on the implications of this, because I think it is not fully understood, and I think these hearings are useful to focus that attention, because we in the past have looked at key sectors of the American economy. The biggest lagging sector of the American economy today is the export sector, and yet that somehow does not get the sort of urgent attention that I think it needs.

Chairman **Gibbons**. Well, I am intrigued by the arguments, and perhaps you need to explain more to me. You talk about the flow of dollars, some $700 billion.

Mr. **Hormats**. That is transactions back and forth. It is not all one direction.

Chairman **Gibbons**. What is causing that? You say that really masks and overrides the trade impact on the dollar. Normally you would think running a deficit like we are doing, that that would turn the value of the dollar around just to begin with. But what is preventing it from turning it around?

Mr. **Hormats**. There are a lot of factors. The $700 billion figure really reflects, every day firms buy and sell currencies just to——

Chairman **Gibbons**. What was that, $700 billion?

Mr. **Hormats**. $700 billion. That is trading, and sometimes people will trade to make a one or two percentage point profit and then they will go back to the currency. And so it is not all that $700 billion. There are days when it might be 350 into dollars and 350 out, so it does not necessarily push the dollar in any one direction at any given point in time.

The point, though, is that the magnitudes are so great, as Fred says, that at the margin, I mean, if five or six big traders for insurance companies or banks decide that the mark is going to strengthen tomorrow, they may decide they will buy $2 billion or $3 billion of marks today to take advantage of it or to prevent themselves from suffering a dollar loss if in fact the mark should strengthen tomorrow.

So that is why you get the sorts of capital movements, short term for the most part, having such a dominant impact. Now, what dominates the thinking of people? People look at movements, anticipated movements in the rate of inflation. That has an impact on currency traders. If there is instability in any part of the world, you see a lot of movement into dollars.

You have seen in the early part of 1983, although not in the last three quarters, you have seen a lot of movement into U.S. stocks and other direct investments. People have bought. Last year 10 percent of our deficit was financed by marks. All of these things show up to a degree in those currency markets.

Now, a lot of it is long-term investment, but a lot of it is sort of short-term covering operations.

Mr. **Bergsten**. Mr. Chairman, could I just butt in on that for a second? I would counsel you not to get mesmerized by these big numbers, $700 billion through the markets. What counts is the net, not the gross. What Bob rightly says is the gross level of transactions has been rising dramatically, because as the level of trade rises the movements of international investment have risen even more so.

The money and capital markets now are to a large extent integrated, and so you get massive movements, not for 1 or 2 percentage points but for one-eighth, one-sixteenth, one-thirty-second of 1 point. There are massive gross movements.

What counts for the exchange rate is the net, however because it is whether the net pressure is coming from the supply side or the demand side. You can have these markets at huge gross levels being very balanced. For example, the dollar-yen rate, which is at an incorrect level, has been very stable now for almost a year, despite huge transactions between the yen and the dollar. The balance has been very, very fine between supply and demand for dollars and yen in and out of each other.

And so one should not be misled by the huge gross volume into thinking that nothing can be done about it, as is often argued, or that somehow capital flows are swamping trade flows. The nets are important.

If we run a current account deficit of $100 billion, we are spending $100 billion net abroad more than we are taking in. That is a negative on the dollar. Somewhere, somebody is therefore spending $100 billion more to invest in the United States than vice versa if the dollar exchange rate is holding firm.

But that is over a year and those are numbers that are much, much smaller, tiny in fact, by comparison to the gross flows going through the foreign exchange markets. My policy point is that you can still affect that net at the margin through policy measures, intervention steps, whatever it may be, if you do it skillfully.

When we were intervening heavily in the markets when I was at Treasury in 1978 and 1979 to support the dollar, we would find that on some days $10 or $20 million, tiny amounts, would move the market substantially. On other days, half a billion would not move it at all.

The point is that what happens net, at the margin, is what counts, and that itself fluctuates very, very sharply day to day. You need skill in being able to affect that with your policies, but you can certainly do so. So do not be mesmerized by the huge numbers into thinking that we are swamped and therefore nothing can be done.

Chairman GIBBONS. I have got a piece of legislation pending—and I did not warn you about it; perhaps you are not even aware of it—that removes the withholding tax on foreign investment. Am I moving in the right direction or the wrong direction?

Mr. BERGSTEN. As I understand that proposal—and it is one that I looked at when I was at the Treasury—its objective would be to promote foreign investment in the United States. Let me ask you: is the objective to promote foreign investment in U.S. securities or foreign borrowing in the United States?

Chairman GIBBONS. It would be foreign investment in U.S. debt obligations.

Mr. BERGSTEN. If that is the objective, then it would promote more capital inflow to the United States. That would strengthen the dollar further, and it would tend to move in the wrong direction in terms of the underlying competitive considerations.

Now, before I therefore dump on it too much, let me just say, like an economist always has to: Compared with what? If it is compared with flows into dollar assets in the Eurocurrency markets, then there would be no net effect on the exchange rates. If the objective of the exercise is to shift the locus of foreign investment in U.S. securities from the Euromarkets to the New York market, and if the net effect were simply to do that rather than to add net to investment in dollar assets, then there would be no effect on the exchange rates.

However, if there were some net increase in investment in dollar assets, whether it is treasuries or anything else, that would tend, all other things equal, to support the dollar further in the exchange markets.

Chairman GIBBONS. Essentially, it would bring it back from the Netherlands Antilles, of all places; bring financial transactions back to the United States. That is one of the objectives.

Mr. BERGSTEN. That is why I put my caveat on, because if all you are doing is shifting the locus of foreign investment in dollar assets, then there is no net impact on the exchange rate.

Chairman GIBBONS. Because anyone that wants to borrow can go through the Netherlands Antilles.

Mr. HORMATS. That is right, and take advantage of that.

Chairman GIBBONS. And so everybody who is serious about borrowing does that?

Mr. HORMATS. It would probably have an effect of creating more transactions in New York that would be the case. But I think it would not necessarily strengthen or weaken—as I understand the legislation, and I would have to look at it again, it would not necessarily strengthen or weaken the dollar. We would get some benefits because you would have more transactions in New York than in Curacao.

Chairman GIBBONS. And we would also not have companies taking foreign tax credits for the surcharges that the Curacao government levies on the transactions, and so we would really pick up revenue by repealing the tax, which I admit is hard to understand, but I wanted to make sure I was not also screwing up the trade picture.

Mr. HORMATS. Why do we not take a look at it and we can give you a written response. That might be best.

Mr. FRENZEL. If the gentleman would yield. It is not going to result in more or less money being borrowed. That is going to be a function of the deficit.

Mr. BERGSTEN. Indirectly, it probably would net out. However, that is a broader point that I might just address, because sometimes the point is made that it really does not make any difference what you do, the current account is going to wind up being financed by capital inflows. Statistically, that is accurate.

Mr. FRENZEL. Or out of savings which we need to put someplace else.

Mr. BERGSTEN. But the question is, at what price? Because two prices are critical in that equation. One is the interest rate and one is the exchange rate. And it makes a big difference in terms of the effect on our economy whether the capital inflow is attracted at a dollar exchange rate which is highly overvalued or comes in when the dollar is at a level which is more consistent with underlying competitive positions.

In either case you will get the capital inflow ex post as you look back, but there is a big difference as to what the price level would be.

Mr. HORMATS. And the interest cost. You will get it if the deficit is large, but you will have to pay a lot of taxpayers' money to pay that interest on it, and that is the other element of the cost.

Mr. FRENZEL. Well, sure. But if you spread your budget to anticipate a deficit of $200 billion, the Government is going to meet its obligations, whatever it has to pay to get the money and from whatever source the money comes. So it really does not make any difference.

Mr. BERGSTEN. The Government is. The question is what happens to the totality of the capital markets and the economy as a whole, and there comes the crowding out, the higher interest rates. That was my point in response to the chairman to that.

Even if you did it with respect to Government securities, for example, you would wind up with an impact on investment in private instruments as a spinoff, and you have to look at the overall effect.

Chairman GIBBONS. What impact is this huge deficit, trade deficit, having on our long-range aim of improving the productivity of our farms and our factories?

Mr. HORMATS. In brief, I think the long-term effect is devastating, because if you take Fred's point and expand on it a second, the newest investment is generally the most productive investment because it is state of the art stuff, by and large. And if someone is looking at a differential of 25 or 30 percent and deciding on where investments are to be made, the probability is, other things being equal, or at least there is a strong possibility that it could be made elsewhere to take advantage of that differential.

And if you start getting a lot of the really new, state of the art stuff being invested elsewhere, that will have a structural impact on our own productivity.

Mr. BERGSTEN. Mr. Chairman, I obviously agree with Bob, having made the point strongly in my opening statement. But let me be devil's advocate for a second and give you the other side of the case.

There are those who say that an overvalued dollar is a good thing for your productivity and competitiveness because it gives you a cold shower.

Chairman GIBBONS. In the short run it does that, sure.

Mr. BERGSTEN. Well, it really forces you to rationalize, cut costs, hold wages down, and put your house in top fighting trim. The Thatcherites in the United Kingdom make that argument.

Remember, after the Thatcher government came in there was a dramatic appreciation of the pound sterling. It went up to $2.60 against the dollar. Since then it has fallen to $1.50, with quite a lot of gyration, but it went up enormously. And even in retrospect, you will get the argument from many British Government officials and even some British industrialists that, since it did not last too long, only a couple of years, it was a real cold shower that had the effect of forcing productivity increases and justifying a tough line on wage negotiations, thereby improving the competitiveness of British industry.

It will be some years down the road before one can really judge that, but I think there is probably a difference between taking a cold shower for a couple of years and sitting in a freezing ocean for a decade. And we have already been there for almost 4 years, and if the dollar were to continue at these levels for a few more I think it would go beyond the cold shower stage.

However, that is the argument that is put on the other side and one has to think about that.

Chairman **Gibbons**. Do you agree with Ambassador Hormats that if we continue these huge deficits for some time that it is going to vastly affect our long-range productivity?

Mr. **Bergsten**. Yes. The simple answer is yes. There is a scenario under which, even with the huge budget deficits, the dollar might come off sharply in exchange markets.

Chairman **Gibbons**. I am not talking about our trade deficit now.

Mr. **Bergsten**. I meant the budget deficit. There is a scenario under which the budget deficit stays very large, you do not come to grips with it, but the dollar still comes off in the exchange markets. That is primarily a scenario of increased inflation expectations, where there is a view that at some point the deficit will be monetized and inflation will erupt. That means, even at high nominal interest rates, real rates are declining. The United States and the dollar are no longer as attractive.

And frankly, I think we had a little taste of that in February. What happened in February is very interesting. The dollar came off 5 or 6 percent, trade weighted, in 1 month while interest rates were rising. My interpretation is that there was some revival of inflation expectations.

The January inflation number came in pretty high. It was an annual rate of a little over 7 percent. The budget submission and the initial debates here in the Congress brought home worldwide that these budget deficits were very big and maybe were not going to go away and maybe were not going to be dealt with. There was perhaps some question whether in an election year the Fed would really hang tough.

And so I think for about a month the markets were again infected by some outbreak of inflation expectations, and so interest rates rose and the dollar came off. I think Chairman Volcker stopped that with some very strong statements toward the end of February about the Fed not monetizing and indeed taking a continued stance of monetary responsibility.

And since then interest rates have been going up rather significantly in real as well as nominal terms, so the dollar has again pushed back up a bit. But I think there is a scenario where that could happen. It could be an extremely unhealthy correction and not the one that I think any of us would want to see.

Mr. **Hormats**. One final thought on that. The productivity point, using again the Thatcher example. There is a difference between a currency appreciating and forcing you to tighten up on your production process and on wages and other costs—that is, one can argue it does improve productivity and tightens up the economy.

If it lasts to the point that actual new investment decisions to invest abroad are made, however, then you get a structural cost, which is I think one of the concerns you have. The other is that if as a result of the deficits you have to pay more interest, your capital base, your capital cost begins to go up and every new investment is made at a higher rate, particularly if you are borrowing at fixed interest at a higher rate, and that undermines your cost structure vis-a-vis that of lower interest rate countries.

Chairman GIBBONS. I wonder if at this point we could take a 10-minute break and go vote. We have got to go vote, and then we could come back.

[Recess.]

Chairman GIBBONS. Let us resume now. I am sorry we lost a lot of our bodies. We have still got the brains here, but we lost a lot of our bodies. [Laughter.]

Mr. Jenkins.

Mr. JENKINS. I want to ask, Fred, as far as your proposed actions, what part the Congress would play in this. And leaving out for a moment the deficit, basically you were saying executive branch action and Federal Reserve action and intervention measures, plus the possibility of some action by Japan itself in your 30 phone call proposal.

Are you making any suggestion for any congressional action other than the fiscal deficit problem itself?

Mr. BERGSTEN. I am not suggesting any legislative action. But there is obviously an interrelationship between the Congress and the administration, which, as I know from my own experience, sometimes with joy and sometimes with sorrow, goes beyond legislation.

Exchange market intervention, which I mentioned, is clearly within the purview of the executive branch, and more explicitly, it is directed by the Secretary of the Treasury under the Bretton Woods Act. It is really his decision as to U.S. intervention policy in the foreign exchange markets. He directs the Federal Reserve System, which implements the policy, but the decisionmaking is in the hands of the Treasury.

Short of legislating some basic change in the Bretton Woods Act, which I would not recommend, what you could do there is the usual run of gentle persuasion of your friends in the executive branch, if you felt so motivated, with the usual array of techniques that you know as well or better than I.

Likewise with actions that other countries might take. That I think is more a matter of redirecting current efforts than of generating new efforts. Let me explain what I mean.

When President Reagan visited Tokyo in November, there was in some sense a major breakthrough, because for the first time the exchange rate issue was put not only on the agenda, but rather near the top of the agenda. And if you will recall the Reagan-Nakasone discussions and communique from that meeting in November, there was great concern expressed about the exchange rate and all sorts of declarations made that getting it in order would be the best thing to do to deal with the trade problem.

So far so good. Unfortunately, no followup. The way the policy response came out went in the direction of accelerating liberalization of the Japanese capital and money markets and talking about longrun internationalization of the yen.

As I mentioned before, those are probably worthwhile objectives from a longrun standpoint, but neither of them would do anything to correct the exchange rate imbalance, certainly in the short run, and they might even go in the wrong direction because, taken literally, liberalization of the Japanese capital markets would primarily mean relaxing some restraints they still have on capital outflow, which if lifted would weaken the yen further.

So the policy response really did not track with the diagnosis as recognized by the two heads of Government. There was one exception to that, the so-called Nakasone bonds, where Japan also pledged to do some heavy borrowing abroad to promote capital inflow to the yen and strengthen the yen exchange rate.

That has been implemented only to the most modest extent, to my knowledge, one issue of $100 million offshore, though the Japanese Government has put to the diet a bill that would authorize the Government itself to borrow offshore. That is an authority it does not now have. But there was very modest action on that.

If you go to what I was suggesting as a second or third best, of asking the Japanese finance ministry, to make those 30 phone calls, frankly, I think, what you would do as the Congress would be to say to the Secretary of the Treasury and the Secretary of State and others who have been besieged with this issue that:

We are delighted that you and the Prime Minister of Japan agreed that this was issue No. 1. However, 6 months have passed and the yen-dollar rate has not changed very much. The things you have got going do not look like they are changing it very much, and so how about asking them to really get serious about those Nakasone bonds, and to make the 30 phone calls in order to carry out the objective that was solemnly agreed on 6 months ago.

I think you could put proposals of that type to the administration in these hearings or elsewhere and use the leverage with which the Congress is so familiar to see to it that they at least gave serious consideration to your proposals.

Frankly, I think you have a gut interest in doing that, speaking in very narrow terms of you on this subcommittee, as opposed to your broader view as Americans, because if the exchange rate, particularly with the yen, does not get corrected pretty soon, you, as well as the people that deal with trade policy in the administration, are going to be deluged with protectionist proposals.

I think the only way to head it off, among other steps that are necessary, is to get the exchange rate back to some kind of equilibrium. That is why I propose these things which are, as I say, second or third best. They are not certainly my top priority list or a list of desiderata, but I think you have got to do them and, I think, particularly in this context, particularly with Japan, you have got a hook, a very natural hook, in the agreement in principle between President Reagan and Prime Minister Nakasone, which, however, somehow en route to its implementation got derailed rather badly.

Mr. **Jenkins**. The unfortunate part, if I recall the administration witnesses correctly, was that in their opinion, beginning in late 1984 and then picking up steam in 1985, the rebound of the world economy is going to straighten out the situation. The best thing we could do would be absolutely nothing, if I recall.

Mr. **Bergsten**. Well, they have expressed that hope. I brought with me some of the latest projections done just 2 weeks ago by Project Link and Wharton Econometrics, though none of these can be taken as gospel for sure. We know that all too well.

Nevertheless, they show U.S. growth continuing at a more rapid pace than growth in the other industrial countries out through 1985. The growth gap narrows. This year it is very sharp with the United States growing about 5.5, Europe maybe 2.5, Japan 3.5. The growth gap narrows, but the United States is still growing faster, which means further deterioration in our trade balance.

You should also should know that even at equal growth rates, United States versus the rest of OECD, the U.S. trade balance deteriorates rather sharply. We have what is called a higher income elasticity of demand for imports than do the other industrial countries. For every percentage point of growth in our GNP, a greater share goes to imports than in the case of the other major countries, so we have to grow more slowly than other countries to come out equally in trade balance terms.

Now, I would not recommend that we shoot for a lower growth rate in order to correct the trade balance, but it does heighten the need to deal with the exchange rate component of the issue, so we are not giving ourselves a double loss, both from the growth gap and from the substantially overpriced dollar.

Mr. **Jenkins**. Ambassador Hormats, you briefly touched upon the problem of the third world debt pressures, and one of the things that you mentioned was the banks themselves had to take some action in addition to what could be done through Exim, Export-Import and the World Bank.

Would it be possible, to restructure those loans in a different manner, possibly with a flexible interest rate in the future after the economy has rebounded, and at the same time, not have those loans classified as a nonperforming asset?

Mr. **Hormats**. Well, you have asked the fundamental queston, and this is in part a regulatory problem, and at the moment my understanding of the view of the regulators is that if there were an attempt to create a longer term security as a substitute for these short-term interest rate observations, the regulators would look very hard at the underlying value of the security. That is to say, was it backed up by reasonable potential to meet the interest or the ultimate principal payment on the security.

I tend to think, and this is more of an intuitive feeling than anything else at this point, that the regulators and the banks can get together and try to find a practice or an approach which enables the regulators not to write down the loans or to force them to be declared nonaccruing, and still, at the same time, pushes out the interest payments over a longer period of time for the high debt countries.

Now, that is not easy to do. I have spent a lot of time over the last couple of weeks looking at that very problem, and the difficulty is that the regulators would want to be sure that that security was backed up by something which would lead them to conclude that it is a marketable security. In fact, it is not going to just have nothing underneath it, and so, I think, that is the direction that people, that the intellectual debate, if you will, is going to proceed in.

Whether they will be able to find something that will achieve that or not, I do not know, but it does have a very real impact on the trade picture, because if these countries have to use 50 percent or 40 percent of their export earnings to repay debt, that means that is a lot of money that they are paying debt with, that they are not buying Lee Morgan's tractors with, or T. Wilson's Boeings.

So, it has a very direct impact on a lot of the heavy capital equipment industries and many other industries in this country. So that when we are looking at this financial thing, the trade financial link is an extremely important one as is, of course, the trade development and the financial development link on the other side of the picture, and I think we will see a lot more.

If the Argentine situation did anything, it was to force people now to focus, as they have not before, on the medium-term solutions of the type you talk about.

Mr. JENKINS. I appreciate your comments. I believe we have to move in that direction.

Mr. HORMATS. I think reality will force us in that direction. I agree with you.

Chairman GIBBONS. I agree with you, too. Let me say, are we in a kind of international gridlock on the dollar? I do not really know the numbers of people that are buying and selling currencies. You mentioned $700 billion in transactions. It seems to me that every place I go—I do not care whether you are behind the Iron Curtain or in one of the least developed countries of the world—everybody knows the value of the dollar in relationship to their currency, and they are always anxious to get their hands on the dollar.

Now, maybe that is just because I am an American and see it from that point of view, but if you go down even in the less sophisticated marketplaces of South America, in some of them, off the beat, all you have to do is to pull out a dollar, and the price gets adjusted real quickly; and I do not care where you are in the world. The same thing happens. They all know the value of the dollar.

Is anybody buying anything else but dollars, except what they have to buy? Has the dollar gotten itself into such a position that the United States is in effect supplying the world's currency? If so, what are the advantages and disadvantages, and what do we do?

Mr. BERGSTEN. That is a very big topic. In fact, I even wrote a book about it once which I will be glad to send you a copy of. It makes lively bedtime reading.

Chairman GIBBONS. I will be glad to send you a check for the book. I am not a cheapskate. [General laughter.]

Mr. BERGSTEN. You do not know how much it costs. [General laughter.]

The fact, Mr. Chairman, is very much as you state. The dollar is by far the predominant currency in the world. It is not as predominant now as it was 20 or 30 years ago with the rise of other economies to a more prominent position.

Depending upon what indicator you use, though, the dollar probably accounts for 60 percent to two-thirds of both private and official holdings of foreign currencies around the world, and particularly at a time when, like the last few years, both the dollar itself is strong and there is all this political and economic uncertainty that you are talking about, people are even more attracted to the dollar.

However, the people you are talking to, I think, are not the ones who primarily affect exchange rates. That is the big traders, international investors, banks, and the like, who do know that there are other currencies. They are very aware that there is a deutsche mark and a pound sterling and a Japanese yen.

Chairman **Gibbons**. They have just been looking for those currencies really to be misplaced in value. That is why they are buying and selling them, is it not?

Mr. **Bergsten**. Well, it depends on what one means by misplaced in value. When I argue, as I have for a long time, that the dollar is overvalued, I am always careful to define my terms, as you know, "overvalued in terms of underlying competitive relationships."

I am not arguing that it is irrational for foreign investors to put their money in the dollar as they have in large magnitudes over these last few years. Interest rates have been attractive here during certain periods. Safe haven considerations do counsel, keeping a large share of your portfolio in the dollar.

I do not say that either the individuals who buy dollars nor the exchange markets themselves are irrational. All I say is that in following the very understandable motivations that they follow, they place the exchange rate relationship way out of kilter in terms of underlying competitive relationships, to wit, where the trade balance has gone now.

There are some people who would present that the other way, and would say we have got a new manifestation of comparative advantage. The United States has a comparative advantage in printing financial assets, and what Bob Hormats and his friends do on Wall Street and what U.S. banks do in issuing certificates of deposit and what the U.S. Treasury does in issuing massive amounts of Federal debt is simply a manifestation of a new comparative advantage.

Our financial assets are very attractive, so we issue a lot of them, and a lot of people buy them, and the dollar exchange rate stays up despite our issuing a lot of them, and some say this is a wonderful thing. We are getting our currency priced very high. That means when you and I go to France, our dollar goes a long way. It means when we want to buy imported cars, aside from the import restraints, our dollars go a long way.

There is an economist's pure welfare argument for having your currency just as strong as it can be, and if you want to put it that way, it is our new comparative advantage, printing pieces of paper. It is a wonderful thing. All we have to do is print paper. The other guy has to work hard and slave to turn out the cars and tractors. You know that argument.

That is the way some people would put it, and it depends on where your external sector fits into your whole economy, how sustainable the situation is, what the effects are on the international economic system as a whole, and a variety of other considerations.

But in all fairness to the critics, I think that is an alternative way to look at it which is most uncongenial to me, but I think is the way some people would put it.

Mr. HORMATS. And then, of course, you have a political problem in proportion to that because it is not a big job creator printing that paper, and in effect what you will have if that, as it has, using Fred's terms, distorted, pushed the dollar off of what it should be in terms of underyling competitiveness, it means that all the major industries are hurting while the particular sector which is not a very labor-intensive sector is doing quite well, and it has all sorts of regional and political and social implications of a fairly profound nature which gets back to your structural points.

Mr. BERGSTEN. You see, at one level, Mr. Chairman, you could say all this business is purely about distribution. Marty Feldstein makes the point quite rightly that if the dollar came off and interest rates were therefore higher in the United States, which he would argue—that is not for sure, but if he were right, then, though you got an improvement in the trade balance, you would take some further hit to the housing industry, because interest rates would be higher.

Now, I am not sure that analysis is right. I do not think anybody knows, frankly, but it is not implausible, and so on one level it is distributional, as Bob just said, and that is another way of saying that it is a new comparative advantage. We print pieces of paper. We sell those. We get our interest rates a little lower than they would otherwise be, and you get different sectors differentially affected.

Mr. HORMATS. The point is, I do not think it is a politically sustainable comparative advantage.

Mr. BERGSTEN. I do not think it is an economically sustainable advantage either, given market sentiments. But to give the devil his due, that is the other side of the argument.

Chairman GIBBONS. Well, how do you get out of it?

Mr. BERGSTEN. I would go back to the things I said before. Long-term, you have got to deal with the budget. That will help bring interest rates off. It will help over time correct the situation.

But if you do not think that is going to happen, and/or you think, as I mentioned, the short-run effect might even be perverse on the exchange rate, and you do not want to inflate it away, which certainly I do not, I would not have the Fed pump up the money stock to get the dollar down. That would be the last thing I would advocate.

Then you have to do some of these more direct second best approaches on the capital flows. Neither will they have wonderful net macroeconomic effects, but I think they could have a real impact on the exchange rate and the trade position, and therefore without any great joy I recommend them.

Mr. HORMATS. One point that Fred mentioned earlier, sort of the other side of the capital control point with respect to Japan is the Nakasone bonds, which I think are a very promising and very constructive approach to the extent that the approach has expanded and increased in quantity, because that, in a way, talking again at the margin, which is what influences exchange rates, a substantial amount of borrowing by Japanese entities like JAL or something like that or the Government of Japan itself would have a strengthening effect on the yen.

Chairman GIBBONS. Well, do they require their people to issue Nakasone bonds? Because why would anybody want to float a Nakasone bond when you can get a lower interest rate inside of Japan?

Mr. HORMATS. Well, in one curious sense, if the Nakasone bond has the desired exchange rate effect, it will get an exchange rate benefit because you will buy, you will be borrowing in effect in the American market, and you will get a strengthening of the yen vis-a-vis the dollar, and therefore you will repay in lower dollars.

Mr. BERGSTEN. Mr. Chairman, let me try to explain. It is an important point. It is exactly what the United States did 6 years ago. If you remember, when the dollar was weak in 1978 and my Treasury created the famous $30 billion rescue program for the dollar, an important point of that was the so-called Carter bonds. We indicated a willingness to borrow $10 billion offshore, mainly deutschmarks and Swiss francs, which we would then use to support the dollar in the exchange markets.

It turned out we borrowed 6 to 7 billion dollars' worth. That was part of a broader package which included a hike in the discount rate and so it was not by itself, but it was an important part of the whole program. What is being suggested now is that Japan and perhaps the Europeans do the same thing, that their governments or official entities borrow heavily offshore, convert those borrowings of foreign currency into the local currency to strengthen the local currency in the exchange markets.

That is what we did when we borrowed marks and francs, and intervened directly in the dollar market with the proceeds of those borrowings to strengthen the dollar. After some back and forth, it worked. It stopped the decline of the dollar immediately, and then after a while it began the rise which took off and went too far, eventually, but it did turn the thing around, and the proposal now is that the Japanese and perhaps the Europeans do the same thing.

In broad terms, it is called compensatory finance. You compensate with official borrowing for the private capital movements that are disequilibrating the exchange markets, and you try to therefore counter what is occurring. Bob is right. One can do that with much less violence to one's principles about markets and such than limiting capital outflows. I am a little skeptical that it would be enough, but I agree that it would be an easier one to try, and it would be worth seeing how far one could get.

Again, the Japanese pledged during the Reagan-Nakasone meeting in November to do that. So far, to my knowledge, only $100 million has been floated, but I have suggested to them that they ought to pick a number, whether it is the $10 billion that we picked or $7 billion or some number and just make very clear that they are prepared to do that much.

You have to go for a psychological effect on the markets as well as the actual effect of the borrowings themselves, and if you say you are prepared to go out and promote $7 to $10 billion of capital inflow into your currency over a reasonably proximate period of time, my belief is that the markets would note that, and there would be a rather sharp appreciation of the yen.

Now, the skeptics and some pure market economists come back and say that just gets all offset. They will borrow more, but then it will flow out or net out. That assumes very perfect capital and money markets, which we do not have in the world, and our own experience shows that you can get net effect from the kind of borrowings that we are talking about, particularly in a case like this where there is widespread agreement, including in Japan, that the yen-dollar rate is out of whack, and what is needed is not a consensus on changing it, but fixing out a practical technique for how to change it. I think you would be moving, in that sense, with a fundamental market perception.

If the Japanese Government came in, supported by the United States, to do a big borrowing of this type, I think the combination of real and psychological effect could get you the move to 200; or so. That really is what is needed at the moment.

Mr. **Jenkins**. I want to ask one ridiculous question that came into my mind a few moments ago. You say that transactions daily will sometimes run $700 billion, and that you can affect the rate at the margin with just a small amount, I believe you indicated, Fred.

Is there any manipulation of the market from within the private sector?

Mr. **Hormats**. In those currency trading operations, not really. They are affected essentially by—the large purchasers or large sellers can move the market a little bit, but there is really no manipulation on a day to day basis. There is no government manipulation in that New York dollar or foreign exchange market.

The key point, though, is when perceptions change. Even a marginal change, two- or three- or four-tenths of a percent, you can get a lot of people who either to take advantage of it and make a profit or to protect their assets will move in that direction, and I think that is where the Nakasone bond or some of these other suggestions come in.

If you influence, you only really have to influence the thinking of a very few of the major actors in the game, the big institutions, the big insurance companies, to get some movement in the currency market in a fairly fundamental direction, and I think the number, the point of $700 billion, most days that will equilibrate.

In other words, you might have—If at the beginning of the day and the end of the day the dollar-yen rate are the same, it means that $350 billion has been to sell and $350 billion has been in there to buy. If you influence the movement of maybe 5 or 10 of that billion—say you have $10 billion more sold than is bought, or you have greater supply than demand for currency. That can move it in a fairly substantial way.

And if it were known the Japanese Government was going to come into the Nakasone bond market for $10 billion, that would have an impact, and I think that that is where one in looking at this and looking at sort of open market suggestions for dealing with it, that is one which is consistent with what the Government of Japan has said, the Japanese authorities who made the point periodically, this is a good idea.

It would be a very helpful thing, because it would take a lot of pressure off the trade side if that were done and done effectively, particularly if at the same time the U.S. Government were to do a little bit of intervention just for the sake of credibility.

Mr. BERGSTEN. Mr. Chairman, one other point. You asked why they would borrow offshore at higher interest rates, and Bob gave an answer, but I am not sure it fully got through. Let me just illustrate again in the Carter bond case.

When we borrowed marks and Swiss francs, we did so when the dollar was at its weakest point. As the dollar then rose, we bought back the marks and francs to repay the Carter bonds. Of course we made a very big profit for the American taxpayer because we borrowed those currencies when our currency was weak. We bought back to repay when our currency was much stronger. And we made close to $1 billion for the American taxpayer through that operation.

Now, its objective was not to reduce the Federal budget deficit, but it had that effect. We made a lot of money. If we had waited, or waited until the next administration came in and the dollar soared further, there would have been profits of several billions of dollars, because of the capital gain on the securities.

So the point Bob made is right. Even though the Japanese borrower would pay a higher interest rate starting out, if the yen then appreciates 10, 15, 20 percent, partly as a result of the operation, then he buys back his dollars to repay at a much lower price and he makes a capital gain that swamps what he lost on the interest rate.

Mr. HORMATS. In effect he is borrowing at a relatively strong currency, and as a result of this operation the currency weakens, and he is paying it back in weaker currency. That is really the way, if the operation works as one would hope it would.

Chairman GIBBONS. Thank you very much. I think you fellows know what you are talking about.

Mr. BERGSTEN. We appreciate your confidence.

Chairman GIBBONS. I think you have contributed a great deal to our understanding.

Mr. HORMATS. Thank you.

Mr. BERGSTEN. Thank you very much.

Mr. HORMATS. Good luck.

Chairman GIBBONS. Thank you.

Mr. HORMATS. If we see the dollar decline by 10 percent over the next couple of weeks, we will know this was successful.

Chairman GIBBONS. Now, we might get the opposite side of all of this. We have Robert Solomon, who is a guest scholar at the Brookings Institution, and Mr. Paul Craig Roberts, who is the William E. Simons Fellow in political economy at the Center for Strategic International Studies at Georgetown University; he has also held other positions. I will not try to enumerate them all at this time. And so has our friend, Mr. Solomon. Let us see, Mr. Solomon. They have got you first on the list, so we will take you first.

Mr. SOLOMON. Thank you, Mr. Chairman.

Chairman GIBBONS. Let me say I appreciate you sitting here and waiting for us to get all of our dumb questions out. If we act like some of your more retarded students, you know what happened. Maybe the next generation of managers will be a little better prepared for the task than we are.

Mr. SOLOMON. Well, I must say, listening to Fred Bergsten got my adrenalin going, Mr. Chairman.

Chairman GIBBONS. I thought it would. Go ahead.

STATEMENT OF ROBERT SOLOMON, GUEST SCHOLAR, THE BROOKINGS INSTITUTION

Mr. SOLOMON. I will be making five points in this statement of mine. Let me start by referring very briefly to the U.S. trade position back in 1980 when the U.S. balance of payments was strong. At its strongest point in recent years, in 1980 and early 1981, our current count was in surplus at a seasonally adjusted annual rate of $13 billion in both the third quarter of 1980 and the first quarter of 1981.

That was a time when the international price of oil was rising rapidly, and most other oil-importing countries, both industrial and developing, were in large deficit on current account. For example, the industrial countries other than the United States had a combined current account deficit of $64 billion in 1980, while the United States had a small surplus.

And it was also in 1980 that the U.S. trade deficit was at its low point of recent years, about $16 billion annual rate in the third quarter of 1980. As you know, it had become normal for the United States to have a trade deficit, given the large and growing net earnings on services and investment income.

Some idea of the strength of the U.S. trade position in 1980 is revealed when we abstract from petroleum imports. The nonoil trade surplus of the United States increased from about $14 billion in 1978 to about $54 billion in 1980. Over those 2 years, U.S. exports rose 57 percent, while imports other than oil rose about 28 percent.

The major reason for this marked strengthening of the U.S. trade position between 1978 and 1980 was the depreciation of the dollar that occurred in 1977-78. From September, 1977, through October, 1978, the average value of the dollar in terms of the currencies of 10 other industrial countries fell by 17 percent.

Over the next 2 years, U.S. exports of manufactured products increased their share of foreign markets significantly, and exports rose to their peak relative to our GNP in 1980, namely, 8.5 percent.

Chairman GIBBONS. Are you telling me that it was Fred's intervention that screwed up the picture? That it was Fred's intervention in the money markets?

Mr. SOLOMON. No; I am not saying that at all. I am trying to demonstrate——

Chairman GIBBONS. I was just trying to get—before he got out of earshot—I was trying to get his attention.

Mr. SOLOMON. No. I am willing to discuss intervention if you want. But the main point I would like to make is that the depreciation that occurred in 1977-78 had this enormous impact on our exports and imports in the next 2 years, and by 1980 we had a very strong balance of payments.

The lessons I draw from this are (1) that our exports and imports are sensitive to exchange rates; and (2) that the U.S. trade position is not chronically weak. In 1980, just 4 years ago, it was very strong. That is my first point.

Now, since 1980, as you know, the trade deficit has increased and it reached $75 billion in the fourth quarter of 1983 and even more in the early months of 1984. Of the increase in the trade deficit, the drop in exports accounts for $17 billion and the advance in imports for $42 billion. Our exports actually reached their low point in the fourth quarter of 1982, and they have gone up since then by some 6½ percent, and therefore have contributed in a minor way to the recovery of this economy in the past year.

It is noteworthy that almost three-fourths of the increase in the trade deficit since 1980 occurred in 1983 when the U.S. economy was recovering vigorously, while the economies of our major trade partners were growng only slowly. Our imports expanded by some $42 billion or 17½ percent from the fourth quarter of 1982 to the fourth quarter of 1983. Our nonoil imports went up 26 percent over that period, while our GNP in nominal terms rose by 10½ percent.

In the first year of a recovery, one would expect imports to increase roughly twice as fast as GNP. Thus, a good part of the increase in U.S imports that actually occurred over the past year is a result of the recovery of the U.S. economy. Meanwhile, the imports of other industrial countries were sluggish. Japan's imports rose only about 7 percent over that period from late 1982 to late 1983, and Europe's imports were almost unchanged in dollar terms. So the difference in rates of economic growth over the past year has had a lot to do with the increase in our trade deficit in that period.

But the enlargement of the trade deficit since 1980 also reflects the appreciation of the dollar, measured against the currencies of 10 large industrial countries. The dollar went up in value by well over 50 percent from late 1980 through early January 1984. It is difficult to quantify the effect of this appreciation, but there is no doubt that the decline in American exports when it occurred, and the increase in imports owe some significant amount to this soaring value of the dollar.

Finally, we have to take account of the debt problems in developing countries. As you know, a number of the developing countries, particularly in Latin America slashed their imports in 1981, 1982, and 1983. U.S. exports to Latin America fell by $15 billion from 1981 to the fourth quarter of 1982, while our total exports declined by $44 billion.

One-third of the fall in our exports during that period was attributable to the drop in Latin American imports from us. While our exports have expanded again since late 1982, those to Latin America have hardly changed.

Let me now turn to the employment effects of the increase in the trade deficit. It is often said that the increase in the trade deficit has resulted in the loss of jobs by Americans. Some observers have even quantified this effect in terms of a precise number of jobs. Mr. Chairman, I believe that such statements are based on faulty reasoning and are, in fact, not valid.

The major cause of both the recession of 1981–82 and the appreciation of the dollar was the restricted monetary policy pursued by the Federal Reserve. This policy was aimed at reducing the rate of inflation, which as you know was at double-digit rates in 1980 and the first half of 1981. The appreciation of the dollar tended to depress American exports and expand American imports.

But we have to ask what would have happened under the same monetary policy if the trade deficit had not increased? With the Fed's restrictive monetary policy in place, our gross national product could not have grown more rapidly than it did. Therefore, if exports had not fallen, other components of gross national product would have had to decline, and this would have reduced employment in other sectors.

On the other hand if imports had been smaller than they were in fact, Americans would have spent more of their incomes on domestic goods and less on imports, and this would have boosted employment. But, since GNP could not rise faster, employment elsewhere in the economy would have been reduced. Thus, if the trade deficit had been smaller, employment in fact would not have been larger, always assuming the same monetary policy in place.

There may have been distributional effects. There would have been more employment in some industries; namely, export industries, and less employment in others, but the total number of jobs, it seems to me, has not been significantly affected by the increase in the trade deficit.

Similar considerations apply to the expansion of imports that has accompanied the recovery since late 1982.

Chairman GIBBONS. Let me interrupt at that point. Let me interrupt you, and you can come right back to your statement.

Do you agree with what Mr. Hormats suggested would occur in the long term, if we continue this deficit. Do you cover that in your statement anywhere?

Mr. SOLOMON. No, I do not. I am looking at the recent experience.

Chairman GIBBONS. Would you care to speculate as to what it would do in the long term?

Mr. SOLOMON. I think, Mr. Chairman, in the long term this deficit is simply not sustainable, as I think Bob Hormats said. He said it is neither politically nor economically sustainable, and I agree with him. And as I shall go on to state, I think it carries the seeds of its own reversal.

Chairman GIBBONS. So you think it is going to correct itself automatically, or semiautomatically?

Mr. SOLOMON. I think, to a large degree, it will correct itself. If you want to call it automatically, it will correct itself by forces that are already in train, as I shall try to demostrate in a moment.

Chairman GIBBONS. Pardon me for interrupting.

Mr. SOLOMON. That is quite all right.

Well, one further point can be made. One can argue that employment was somewhat higher as a result of the dollar appreciation that in fact increased or contributed to the increase in the trade deficit. The rise in the value of the dollar helped to lower the rate of inflation in the United States. With prices lower than they would have been in the absence of that appreciation of the dollar, the monetary targets aimed for by the Federal Reserve permitted more of nominal GNP to appear as real output, and this in turn resulted in a higher level of employment than would have prevailed with the same monetary policy and a lower value for the dollar.

Let me now talk a little bit about the prospects for the deficit, which is the point we were just referring to, Mr. Chairman.

As I have indicated, the increase in the trade deficit since 1980 has been the result of three factors: The appreciation of the dollar, the faster growth of the U.S. economy since late 1982, and the repression of imports by Latin American countries owing to the debt crisis. The dollar reached its peak in early January of this year. From January 12, which happened to be the high point in the trade weighted value of the dollar, to April 2, the beginning of this week, the average value of the dollar came down by 5½ percent; against the German mark, it has fallen by almost 8 percent; and against the yen, by about 4½ percent. This depreciation of the dollar has taken place, despite the fact that U.S. interest rates have been increasing in early 1984.

I believe the main explanation for the decline in the value of the dollar is that market participants have come to realize that the trade and the current account deficits are large and growing, and will require a lower dollar to be corrected.

Foreign exchange markets, like the stock market and other so-called asset markets, are strongly influenced by expectations. In light of the trade and current account deficits, expectations have switched and, generally speaking, a falling dollar is now anticipated, and such expectations tend to be self-fulfilling in my view.

As the dollar continues to depreciate, American exports and imports will both be affected, and just as we experienced a marked strengthening of our balance of payments in 1979–80, once again the lower value of the dollar will lead to a smaller deficit in trade and the current account.

It is also likely that the difference in growth rates between the United States, on the one hand, and Europe and Japan on the other will narrow before long. Our rate of growth will slow down from the rapid pace of 1983 and early 1984, and there are numerous signs that economic expansion is picking up in Europe and Japan.

As these developments unfold, they will be reflected in imports. The rate of growth of our imports will decelerate and then that of Europe and Japan will accelerate, and this too will tend to reduce the trade deficit.

One cannot be as sure about the Latin American situation, though I must say that our major market in Latin America, Mexico, shows some signs of recovery and of increasing its own imports, which come mainly from the United States.

In general, therefore, I conclude that the large trade deficit of the United States is reversible. The main forces that will reduce the deficit are already at work—a declining dollar and a narrowing of differences in growth rates between the United States and other industrial countries.

The widespread belief that the trade deficit is an inevitable reflection of the budget deficit is, in my view, incorrect. The forces that I have just referred to will reduce the trade deficit, whether or not anything is done soon to cut the budget deficit. If the budget deficit remains large as the trade deficit decreases, the result will be greater crowding out of domestic spending for housing and business investment.

There is no reason why the effects of the large budget deficit have to be reflected in the foreign accounts, rather than the domestic U.S. economy. I hope it is clear that this is not a reason to be complacent about budget deficits, and I am not. There are ample domestic reasons to do something about the budget. Furthermore, a declining trade deficit makes it more urgent to reduce the budget deficit, since the impact of that deficit will otherwise fall more heavily, on domestic housing and domestic business investment.

Let me say a few words about the proposals that have been put forward for doing something about this situation, Mr. Chairman. Since I believe that the trade deficit will correct itself, I see no need for special measures to deal with it. The 5-percent depreciation of the dollar since January is roughly equivalent to a 5-percent surcharge on imports and a 5-percent subsidy to exports. But even if forces were not underway to reduce the trade deficit, I would strongly advise against any import surcharge. A measure like that, if it reduced imports, would tend to strengthen the dollar. A higher value for the dollar would offset the effect of the import surcharge. I am sure you have been told that by other witnesses.

Furthermore, the use of such a measure by the United States would set an example for other countries. In fact, it might provoke instant retaliation, and all parties would be worse off. And I think the same considerations apply to other forms of import restriction.

Intervention in foreign exchange markets is not a powerful influence on exchange rates, in my view, but I believe that the Treasury and the Federal Reserve should have intervened more actively in recent years. When the dollar is going down, it would not be appropriate to intervene to push it down faster, but when the depreciation falters, as it has done in recent weeks, a signal from the monetary authorities in the form of intervention would do no harm, and might do some good.

Finally—and it hardly needs to be said—a shift in the mix of fiscal and monetary policies in the United States is highly desirable for domestic reasons. It would also, by lowering interest rates from where they would otherwise be, reinforce the tendency for the dollar to depreciate and in time, with a lag, help to bring about a reduction of the trade deficit.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF ROBERT SOLOMON, GUEST SCHOLAR, THE BROOKINGS INSTITUTION [1]

In this statement, I shall (1) examine the U.S. balance of payments and trade position before the recent increase in the trade deficit, showing how strong that position was in 1980, (2) explain why the trade deficit has increased since then, (3) correct a common misconception about the employment effects of the trade deficit, (4) present the reasons why I believe the situation is self-correcting, and (5) appraise some of the proposals that have been put forward for dealing with the trade deficit.

U.S. TRADE POSITION IN 1980

The U.S. balance of payments was in its strongest condition of recent years in late 1980 and early 1981. The current account (goods, services, investment income, and unilateral transfers) was in surplus at a seasonally-adjusted annual rate of more than $13 billion in the third quarter of 1980 and in the first quarter of 1981. That was a time when the international price of oil was rising rapidly and most other oil-importing countries, both industrial and developing, were in large deficit on current account. For example, the industrial countries other than the United States had a combined current-account deficit of $64 billion in 1980, while the United States had a small surplus.

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[1] The views expressed in this statement are the sole responsibility of the author and do not purport to represent those of the Brookings Institution, its officers, trustees, or other staff members.

It was in 1980 that the U.S. trade deficit was at its low point, amounting in the third quarter to $16 billion (annual rate). It had become normal for the U.S. merchandise trade balance to be in deficit, given the large and growing net earnings on services and investment income.

Some idea of the strength of the U.S. trade position in 1980 is revealed when we abstract from petroleum imports. The non-oil trade surplus increased from $13.9 billion in 1978 to $53.8 billion in 1980. Over these two years, U.S. exports rose by $82.1 billion, or 57 percent, while imports other than oil rose 27.5 percent. In real, or inflation-adjusted, terms, exports advanced more than 22 percent and total imports fell; non-oil imports were about unchanged.

The major reason for this marked strengthening of the U.S. trade position between 1978 and 1980 was the depreciation of the dollar that occurred in 1977–78. From September 1977 through October 1978, the average value of the dollar in terms of the currencies of ten other industrial countries fell by 17 percent. Over the next 2 years, U.S. exports of manufactured products increased their share of foreign markets; according to the OECD, while manufactured imports of America's trade partners expanded 14 percent in 1979–80, our exports of manufacturers increased 19.5 percent. In 1980 total American exports reached their peak relative to our gross national product—8.5 percent.

Two conclusions stand out from this episode. First, U.S. exports and imports are sensitive to movements of exchange rates. Second, the U.S. trade position is not chronically weak; in 1980 it was very strong.

INCREASE IN TRADE DEFICIT SINCE 1980

From its low point of $16 billion in the third quarter of 1980, the U.S. trade deficit increased to $75 billion (annual rates) in the fourth quarter of 1983 (and grew even larger in the first two months of this year). Of the $59 billion increase in the deficit, the drop in exports accounts for $17 billion and the advance in imports for $42 billion. Exports were at their low point in the last quarter of 1982, which was also the trough of the 1982 recession. After that, exports rose $12.5 billion, or 6.5 percent, contributing to the recovery in 1983.

It is noteworthy that almost three-fourths of the increase in the trade deficit since 1980 occurred in 1983, when the U.S. economy was recovering vigorously while the economies of our major trade partners were growing only slowly. Our imports expanded by $42.3 billion, or 17.7 percent, from the fourth quarter of 1982 to the fourth quarter of 1983. Non-oil imports went up 26.1 percent. Over the same period, GNP increased 10.5 percent. In the first year of a recovery, one would expect imports to increase about twice as fast as GNP (in technical terms, I assume that the income elasticity of demand for imports is about 2). Thus a good part of the increase in U.S. imports and therefore in the trade deficit was a consequence of the U.S. recovery in 1983. Meanwhile, the imports of other industrial countries were sluggish. Japan's imports rose about 7 percent over the four quarters ending October-December 1983, and Europe's imports were almost unchanged, in dollar terms. The difference in rates of economic growth was therefore a major factor in the increase in our trade deficit in 1983.

The enlargement of the trade deficit since 1980 also reflects the appreciation of the dollar. Measured against the currencies of ten large industrial countries, the dollar went up in value by well over 50 percent from late 1980 to early January 1984. The effect is difficult to quantify, but there is no doubt that the 20 percent decline in American exports from their peak in early 1981 to their low point in late 1982 owes much to the soaring value of the dollar. Similarly, American imports, though they moved with U.S. GNP, are undoubtedly higher than they otherwise would be as the result of the appreciation of the dollar.

Finally, account has to be taken of the debt problems of developing countries in general and of Latin America in particular. The debt crisis that erupted in 1982 led these nations to slash their imports. U.S. exports to Latin America fell by $15.3 billion from their average in 1981 to the fourth quarter of 1982, while total exports declined $44.4 billion. While American exports expanded again in 1983, those to Latin America hardly changed.

EMPLOYMENT EFFECTS OF INCREASE IN TRADE DEFICIT

It is often said that the increase in the trade deficit has resulted in the loss of jobs by Americans. Some observers, have even quantified this effect in terms of a precise number of jobs. I believe that such statements are based on faulty reasoning and are not valid.

The major cause of both the recession of 1981–82 and the appreciation of the dollar was the restrictive monetary policy pursued by the Federal Reserve. This policy was aimed at reducing the rate of inflation, which was at double-digit rates in 1980 and the first half of 1981.

The appreciation of the dollar tended to depress American exports and expand American imports. But, we have to ask, what would have happened under the same monetary policy if the trade deficit had not increased. With the Fed's restrictive monetary policy in place, gross national product (GNP) could not have grown more rapidly than it did. Therefore, if exports had not fallen, other components of GNP would have had to decline, and this would have reduced employment. If imports had also been smaller, Americans would have spent more of their incomes on domestic goods, and this would have boosted employment. But, since GNP could not rise faster, employment elsewhere in the economy would have been reduced. Thus, if the trade deficit had been smaller, employment would not have been larger.

Similar considerations apply to the expansion of imports that has accompanied the recovery since late 1982. Slower growth of imports would have meant faster growth of GNP. Whether this was desirable can be questioned. In any event, it was not possible, given the Fed's monetary policy.

Actually, the case can be made that employment was somewhat higher as a result of the dollar appreciation that increased the trade deficit. The rise in the value of the dollar helped to lower the rate of inflation. With prices lower than they would have been in the absence of the appreciation of the dollar, the monetary targets aimed for by the Federal Reserve permitted more of the nominal GNP to appear as real output. This, in turn, resulted in a higher level of employment than would have prevailed with the same monetary policy and a lower value for the dollar.

PROSPECTS FOR U.S. TRADE DEFICIT

As indicated above, the increase in the trade deficit since 1980 has been the result of three factors: the appreciation of the dollar, the faster growth of the U.S. economy since late 1982, and the repression of imports by Latin American countries owing to the debt crisis.

The dollar reached a peak in early January. From January 12 to April 2, the average value of the dollar fell by 5.4 percent. Aganist the German mark it has come down 7.9 percent and against the yen it has depreciated 4.4 percent. This depreciaiton of the dollar has taken place despite the fact that U.S. interest rates have been increasing. I believe the main explanation for the decline in the value of the dollar is that market participants have come to realize that the trade and current-account deficits are large and growing and will require a lower dollar to be corrected. Foreign exchange markets, like the stock market and other so-called asset markets, are strongly influenced by expections. In light of the trade and current-account deficits, expectations have switched and a falling dollar is now anticipated. Such expectations are self-fulfilling.

As the dollar continues to depreciate, American exports and imports will both be affected. Just as we experienced a marked strengthening of our balance of payments in 1979–80, once again the lower value of the dollar will lead to a smaller deficit in trade and the current account.

It is also likely that the difference in growth rates between the United States, on the one hand, and Europe and Japan, on the other, will narrow before long. Our rate of growth will slow from the rapid pace of 1983 and early 1984. And there are numerous signs that economic expansion is picking up in Europe and Japan. As these developments unfold, they will be reflected in imports. The rate of growth of our imports will decelerate and that of Europe and Japan will accelerate. This too will tend to reduce our trade deficit.

One cannot be as sure about the third influence on our exports—the capacity of Latin America to increase its imports. It will take a number of years for the debt problem to be resolved. But the largest Latin American importer from the United States—Mexico—has apparently begun to recover and its imports have increased somewhat.

In general, therefore, I conclude that the large trade deficit of the United States is reversible. The main forces that will reduce the deficit are already in train: a declining dollar and a narrowing of differences in growth rates between the United States and other industrial countries.

The widespread belief that the trade deficit is an inevitable reflection of the budget deficit is, in my view, incorrect. The forces that I have just referred to will reduce the trade deficit whether or not anything is done soon to cut the budget deficit. If the budget deficit remains large as the trade deficit decreases, the result will be greater crowding out of domestic spending for housing and business investment. There is no reason why the effects of the large budget deficit have to be reflected in the foreign accounts of the United States rather than in the domestic economy. I hope it is clear that this is not a reason to be complacent about budget deficits. There are ample domestic reasons to do something about the budget. Furthermore, a declining trade deficit makes it more urgent to reduce budget deficits, since their impact will otherwise fall more heavily on investment outlays in the United States.

PROPOSALS FOR REDUCING TRADE DEFICIT

Since I believe that the trade deficit will correct itself, I see no need for special measures to deal with it. The 5 percent depreciation of the dollar since January is roughly equivalent to a 5 percent surcharge on imports and a 5 percent subsidy to exports.

But even if forces were not under way to reduce the trade deficit, I would strongly advise against an import surcharge. A measure like that, if it reduced imports, would tend to strengthen the dollar. A higher value for the dollar would offset the effect of the import surcharge. Furthermore, the use of such a measure by the United States would set an example for other countries. In fact, it might provoke instant retaliation and all parties would be worse off. The same considerations apply to other forms of import restriction.

Intervention in foreign exchange markets is not a powerful influence on exchange rates. But I believe that the Treasury and the Federal Reserve should have intervened more actively in recent years. When the dollar is going down, it would not be appropriate to intervene to push it down faster. But when the depreciation falters, as it has done in recent weeks, a signal from the monetary authorities, in the form of intervention, would do no harm and might do some good.

Finally, it hardly needs to be said that a shift in the mix of fiscal and monetary policy is highly desirable for domestic reasons. It would also, by lowering interest rates from where they would otherwise be, reinforce the tendency for the dollar to depreciate and, in time, help to bring about a reduction of the trade deficit.

Chairman GIBBONS. Thank you.

We are going to have to declare a short recess. I have to go vote, and the other members have to vote. I will be right back. It is an important vote. If this one should pass, the deficit will rise.

[Recess.]

Chairman GIBBONS. Mr. Roberts, you are next. I apologize again to both of you for having to leave.

STATEMENT OF PAUL CRAIG ROBERTS, THE WILLIAM E. SIMON FELLOW IN POLITICAL ECONOMY; CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES OF GEORGETOWN UNIVERSITY

Mr. ROBERTS. Thank you, Mr. Chairman. I have a very brief statement of about four pages.

Chairman GIBBONS. All right, sir; you may proceed.

Mr. ROBERTS. I am pleased to see Mr. Solomon does agree with me on many of the essential points. There are three basic causes of the current U.S. trade deficit: First, the strength and timing of the U.S. economic recovery; second, declines in our exports to countries that are experiencing problems with their external debt and that are trying to comply with the conditions required by the International Monetary Fund; and third, the appreciation of the dollar in the foreign exchange market since its low in 1980.

Despite predictions to the contrary, the U.S. economy has experienced a strong and balanced recovery. A natural consequence of recovery is that rising demand spills over into imports. Since the United States is the first to recover from world recession, our imports have risen before those of our trading partners; as our purchases from abroad help other countries recover, their imports will also rise and help to reduce our trade deficit.

The United States is a major exporter to developing countries, and their financial problems have led to a sharp drop in our exports. For example, our exports to Mexico dropped by 50 percent between 1981 and 1983, and our overall trade balance with non-OPEC developing countries worsened by $22 billion over that period. In contrast, our deficit with Japan only widened by $3.8 billion during the same period as a result of increased imports from Japan.

The appreciation of the dollar since 1980 has made foreign goods cheaper in the United States, and U.S. goods and services more expensive abroad. Various changes in U.S. economic policy account for the strength of the dollar today compared to its weakness in 1980. One important factor is the sharp decline in U.S. inflation. Another important factor is the marked improvement in U.S. business investment as a result of the 1981 tax cut. These two policy changes have substantially improved U.S. economic performance and prospects relative to the rest of the world.

Business conditions and prospects abroad, especially in Europe, have not kept pace with those in the United States. In addition, turmoil in the Middle East, Latin America, and elsewhere, together with the threat of capital controls and expropriations have enhanced the safe haven aspect of investment in the United States.

People who claim that the dollar is overvalued overlook that the bulk of transactions in the foreign exchange markets consists of capital transactions. Investors at home and abroad constantly judge the relative attractiveness of assets denominated in different currencies. Investors act on their assessments of risk and after-tax rates of return. The strength of the dollar reflects the outcome of these decisions.

In these circumstances, efforts to artificially devalue the dollar are pointless. The dollar will naturally depreciate as other countries improve their prospects. To attempt to force a depreciation of the dollar would require a massive, unsterilized intervention in the foreign exchange market which would weaken the dollar as a result of a faster money growth and higher inflation. If the price of a weaker dollar is higher inflation, where is the gain?

Despite the strength of the dollar, U.S. exports of goods and services rose by $31 billion between the fourth quarter of 1982 and the fourth quarter of 1983, accounting for 8 percent of the growth of real GNP over the period, an unusual performance, considering that exports typically remain flat during the first year of economic recovery.

The facts do not support the claim that the strength of the dollar is due to record inflows of foreign capital attracted by high U. S. interest rates. Inflows of foreign capital to the United States in 1983 actually dropped by $5 billion, which works to weaken the dollar. The dollar's strength would seem to have more to do with the $69 billion drop in outflows of U.S. capital to other countries. The argument that U.S. investors are bidding down the value of foreign currencies by increasing their dollar denominated investments in the United States would seem more in keeping with the facts.

The argument that the strength of the dollar is due primarily to high U.S. interest rates is also inconsistent with the fact that interest rate differentials moved against the dollar during the period that it appreciated. From the beginning of 1981 to the end of 1983, the dollar rose by 38 percent against the German mark, 83 percent against the French franc, and 14 percent against the Japanese yen. During this time, the gap between U.S. and foreign interest rates narrowed by 5 percentage points in the case of Germany; about 9 percentage points in the case of France; and about 6 percentage points in the case of Japan. Similarly, during the recent period of dollar depreciation, interest rate differentials have moved in favor of the United States.

In recent weeks there has been too much unschooled rhetoric about the trade deficit from government officials who should know better. This rhetoric has encouraged autarkic and protectionist tendencies in opposition to the free movement of goods and capital that the U.S. has championed in the postwar period. Protectionists today see a weak dollar as an alternative to tariffs and quotas. They want an unfavorable exchange rate that stops competition from imports. When the Chairman of the Council of Economic Advisers claims that a strong dollar is costing millions of U.S. jobs, he is putting a new veneer on the old sentiment to "buy American."

So far, the recovery has created almost 5 million jobs in the U.S., and it is unclear how the economy could have handled the jobs that some claim have been lost to imports. The fears expressed by some that imports are a threat to the recovery are contradicted by the fears of Federal Reserve officials who believe that the economy is growing at an unsustainable and disturbing rate, and who are threatening to slow the recovery by letting interest rates rise.

The hysteria over the trade deficit cannot be justified. The best action to take is to avoid a policy of tight money and high taxes that would stop the U.S. locomotive from pulling our trading partners out of recession.

Looking to the future, a most helpful action would be to curtail the rate of growth of future Social Security and medicare benefits. The current growth path of these benefits implies a payroll tax of 25-percent. American labor already faces competitive pressures in domestic and foreign markets. A 25-percent payroll tax would price U.S. labor out of most markets. It implies very high prices and a very high wall of protectionism.

Thank you, Mr. Chairman.

[Attachments to the prepared statement follow:]

THE BALANCED NATURE OF THE CURRENT EXPANSION

As the table shows, the current expansion has been remarkably well balanced, rather than distorted by high interest rates as some had feared. Above-normal gains have been made in the interest-sensitive areas of spending on consumer durables such as autos and appliances, as well as in business capital spending and housing. The trade balance has been weak but exports have risen rather than remaining flat as in the first year of the average of previous expansions.

TABLE 1.—DISTRIBUTION OF REAL GNP GROWTH DURING THE FIRST YEAR OF EXPANSION

[As percent of total]

	Average of five previous expansions	Current expansion
Consumer spending	52.3	57.3
Durables	19.3	24.0
Business capital spending	7.6	21.9
Housing	15.2	16.6
Inventories	26.4	34.2
Federal purchases	−2.8	−8.7
State and local purchases	7.5	0.8
Net Exports	−6.0	−21.9
Exports	0.6	4.5
Imports	−6.4	−26.5
Memo: Total growth in real GNP in percent	6.8	6.2

Source: U.S. Treasury Department.

TABLE 2.—SHIFTS IN U.S. TRADE BY COUNTRY OR COUNTRY GROUP, 1981–83 [1]

[In billions of dollars]

	1981	1983	Shift
Trade with Mexico:			
U.S. exports	18.2	9.1	−9.1
U.S. imports	−13.8	−16.8	−3.0
Balance	4.4	−7.7	−12.1
Trade with other non-OPEC LDCs: [1]			
U.S. exports	49.7	46.4	−3.3
U.S. imports	−53.1	−60.4	−7.3
Balance	−3.5	−14.1	−10.6
Trade with Japan:			
U.S. exports	21.8	21.7	−0.1
U.S. imports	−37.6	−41.3	−3.7
Balance	−15.8	−19.6	−3.8
Trade with other industrial countries:			
U.S. exports	120.1	105.3	−14.8
U.S. imports	−106.7	−113.0	−6.3
Balance	13.4	−7.8	−21.1
Trade with East Europe:			
U.S. exports	4.4	2.9	−1.5
U.S. imports	−1.6	−1.4	0.2
Balance	2.9	1.5	−1.3
Trade with OPEC:			
U.S. exports	21.1	15.1	−5.9
U.S. imports	−49.9	−25.2	24.7
Balance	−28.8	−10.0	18.8

[1] All data on balance of payments basis, except trade with "other non-OPEC LDCs" which is on roughly-comparable Census Customs-value basis.

Source: U.S. Treasury Department.

TABLE 3.—U.S. CAPITAL ACCOUNT, 1982–83

[In billions of dollars]

	1982	1983
Recorded inflows of foreign capital to United States	88	83
Recorded flows of U.S. capital to other countries	–118	–49
Net recorded capital	–30	34
Statistical discrepancy	41	7
Net recorded capital plus discrepancy	11	41
Current account deficit	–11	–41

Source: U.S. Treasury Department.

Chairman GIBBONS. Thank you. Both of you gentlemen give us a lot to think about. It certainly proves again the fact that this is not a very clear or a very simple subject that we are dealing with, and that most of us need to think a lot more before we open our mouths.

Some of us can only think, though, when we are talking; that is the problem. You gentlemen have perfected the idea of thinking when you are writing, and you do not do as much damage that way. But the spoken word just keeps going.

So I appreciate what you have said there. Both of you gentlemen have listened to each other, and you have listened to the other witnesses. Wherein do you two gentlemen disagree?

Mr. SOLOMON. I might offer one disagreement with Fred Bergsten.

Chairman GIBBONS. I am sorry?

Mr. SOLOMON. I would offer one place where I would diverge from what you heard from Fred Bergsten. It seems odd to me to be urging Japan, a country with a large surplus in the current account of its balance of payments, to go out and borrow. A country that has a surplus in its balance of payments has to be lending to the rest of the world.

It is a little bit perverse to suggest that it should go out and borrow. And his use of the analogy with the U.S. position in 1978 when the dollar was weak is not complete, because at that time we had a large current account deficit, and it made sense for us to borrow abroad and to help finance that deficit. Japan has a surplus which is one of the reasons why I would expect the situation to be reversed. I would expect the yen to continue increasing, given it's large current account surplus.

So if we are to do something, it seems to me rather unreasonable to ask the Japanese with their surplus to go out and borrow. If we are really that anxious, perhaps we ourselves should be doing more intervention, buying Japanese yen with dollars.

Mr. ROBERTS. Mr. Chairman, if I might answer the question in a more general way, I think that Mr. Solomon and I are aware that there are natural correcting forces in any sort of disequilibrium situation, whereas I believe Mr. Bergsten is inclined, anytime he sees any change on the economic horizon, to want to counter that with some form of Government intervention.

And often the intervention, then, sets in motion a whole different set of changes which were unpredictable, and which then someone else wants to counter with yet another intervention, and in that way you get lost on a path that you cannot predict or control or have any rational expectations of the outcome.

If you will remember, it was recently that the Congress was holding hearings on the weak dollar.

Chairman GIBBONS. Oh, yes; I remember.

Mr. ROBERTS. So I think that the basic difference is that Mr. Solomon and I expect that the problem will remain less long and be less severe than people who tend to create a crisis out of any change in the economic environment.

Chairman GIBBONS. Well, let me ask this question, then. How did we get ourselves in this mess? I recognize that international trade is now a far larger portion of our GNP—when I first came on this committee, international trade was less than $50 billion a year in and out. Now it is roughly $500 billion in and out, and so the deficits and the surpluses are obviously going to be larger.

But in my memory, we have never had a deficit that approached this deficit—maybe I am wrong—when it is compared to our GNP or compared to just plain dollars or anything else. And as Chairman of the Trade Committee I feel that I have some duty to inquire into the causes of it and see if there must be some corrective action taken.

So that is a preface for my question. How did we get ourselves in what appears to me to be a mess with a deficit of about $100 billion on the merchandise side and, say, a current account deficit of probably $50 or $60 billion next year? How did we get here?

Mr. ROBERTS. Mr. Chairman, I will make an answer to that and I am sure Mr. Solomon has one, and I will not try to cover the whole ground. I will just focus on two things that happened.

I think one is that foreign products have become more competitive. I can remember growing up with the automobile, and the Japanese car was a joke. They were terrible. No one would have one. They were tinny. They had no comfort or performance, and today that is no longer the case. The same thing is true of European cars, particularly cars from Germany which are now prized and sought after and are regarded as status symbols and signs of personal success.

So that is one change. We have been living in a period in which foreign countries have found products that they can successfully market here.

Another change during this period has been a deterioration in the competitiveness of American labor. I think this was due to a combination of the inflation and the progressive income tax because any cost-of-living adjustment or any wage increase resulted in a rising tax burden on labor. This meant it required a larger and larger gross wage increase to give labor a net wage increase.

And I think these factors interacted in a way that escalated the cost of American labor. I can remember when I was a student studying management and economics, which was not that long ago. Our professors told us we did not have to worry about high priced American labor relative to the rest of the world, because American labor was so productive and had so much capital to work with. This high productivity offset the high relative wages of American labor.

Well, this is no longer a situation unique to the United States. Today there are other industrial countries with large and productive capital stocks and therefore the labor cost disadvantage has become more of a factor in the picture. I think the combination of inflation with the progressive income tax during the 1970's did a great deal to erode the competitiveness of American labor in markets both at home and abroad.

Mr. SOLOMON. May I, Mr. Chairman, diverge a little bit from Mr. Roberts? It seems to me that the most important part of the answer to your question lies in the fact that the international value, exchange rate value of the dollar, has gone up by 50 to 60 percent since 1980. That overwhelms any change in the competitiveness of American labor and almost anything else you can mention. That is a tremendous appreciation of the dollar, larger than anything we have ever seen.

Now what brought that about? I do not want to give you a lengthy dissertation here, but I think to a large degree it was a response to the very strong anti-inflationary policies followed by the Federal Reserve. I am not criticizing the Federal Reserve. I am just making a statement of fact.

I think it is the high interest rates. As you know, there were times when our interest rates were close to 20 percent in the periods 1981 and 1982 and the fear in markets that interest rates might jump again has also had an influence in holding up the dollar, just so people could be on the safe side.

I think that is the No. 1 part of the answer to your question, how did we get into this situation. And the second most important is that over the past year when a good part of the growth of this deficit occurred, to repeat what I said in my formal testimony, during the past year we have had a very vigorous expansion in this economy, which is a good thing for all of us and for the rest of the world as well. But that helps to explain a lot of the rest of the increase in the deficit.

Now your question was how did we get into this mess and I might just state, I do not know how much of a mess it really is, Mr. Chairman.

Chairman GIBBONS. Well, let me say it is a political mess. The problem that the chairman has is how do I prevent us from doing something worse? Elections are coming up and people say we have to have a solution. Gibbons, where is your solution?

Mr. SOLOMON. I guess what I am saying to you as an economist is I am not sure it is that serious an economic mess, though the existence of that deficit, of course, nourishes those who want all sorts of protection. I fully understand that.

Chairman GIBBONS. But your presumption, your statement is based upon the expectation that this is self-correcting and that it will correct itself in a reasonably——

Mr. SOLOMON. It will take a while.

Chairman GIBBONS. In a reasonable period of time.

Mr. SOLOMON. Yes, sir.

Chairman GIBBONS. But if it persists for a number of years it is going to be disasterous.

Mr. SOLOMON. Well, it could be in terms of the sorts of political pressures you are talking about. I find it highly unlikely that it will persist for anything like that long.

Chairman GIBBONS. I understand, but let us just set aside for the purposes of speculation—and maybe it is impossible to do it—your presumption that it will not last and that it is a self-correcting operation.

Suppose we, like Rip Van Winkle, wake up 3 or 4 years from now, and we still have a deficit that is approaching $100 billion on the merchandise side, and it has persisted like that? Well, that is an awfully hypothetical question, because you do not agree that it will stay that way, but you would have to say if it ended up in that way we would have to do something.

Mr. SOLOMON. Well, let me just be the devil's advocate and ask why would you have to do something?

Chairman GIBBONS. Well, there again I would say I am usually the kind of fellow that likes to play it safe, which means I do not like to go off exploring untested remedies, but I do not always prevail around here.

Mr. ROBERTS. Mr. Chairman, let me suggest if we did wake up in 5 years and we find the identical situation it would suggest to me that American business had lost the ability to compete in markets and I would be looking for the cause of that. It might reside in the tax law. It might reside in a failure of management. It could also be a problem with the compensation of labor. And I would look to those factors if there is a long-term serious imbalance in the merchandise trade deficit.

Mr. SOLOMON. May I add to that, Mr. Chairman? If as Rip Van Winkle we woke up several years from now and still found we had that deficit, that would imply that the exchange rate of the dollar was still high and had not depreciated, and that tells us something about the attitude of the rest of the world toward the dollar, a subject which you discussed with our predecessors up here at this table.

I find it hard to believe that that will happen, but it could—anything can happen. Furthermore, I think you should think in terms of a deficit relative to our GNP, because 5 years from now a $100 billion deficit will look smaller relatively.

But at any rate, if it remains, that means the dollar will not have depreciated, and that is telling us something about the attitude of the rest of the world toward the value of the dollar.

Mr. ROBERTS. You see, the wild card is, Mr. Chairman, that trouble and insecurity in the world could escalate, in which case the safe haven aspects of the dollar could override, conceivably, though I do not think it is likely, but conceivably could override the kinds of normal readjustments that a large trade imbalance causes to come about.

Mr. SOLOMON. Let me give a more concrete example, Mr. Chairman. Each time we had an oil shock, in late 1973 and again 1979–80, the dollar strengthened for fairly clear reasons. We are much more self-sufficient. Though we are oil importers, we are much more self-sufficient than Japan and Germany.

Now suppose something happened in the Straits of Hormuz and we had an interruption in the supply of oil for a lengthy period of time. I think that is unlikely but it is possible. That would tend to strengthen the dollar and it is unpredictable but it would tend to maintain this trade deficit we are talking about. That is just one example.

Chairman GIBBONS. Do you see this deficit as being a potentially unintended vice that makes our farms less valuable and our factories less valuable?

Mr. SOLOMON. Well, I am not sure it does that, Mr. Chairman. I can understand that particular industries that are suffering from import competition—and Caterpillar Tractor must be the prime example, and I have no doubt that you have heard from Caterpillar Tractor.

Chairman GIBBONS. Yes, sir. We had them here this morning.

Mr. SOLOMON. I did not know that. There are particular companies and particular industries that, of course, suffer from the fact that imports have a low price and some companies that specialize in exports have been hurt, and that may also be true of Caterpillar Tractor.

But generally speaking our manufacturing sector as a whole has held up very well and it has maintained its relationship to GNP as GNP has increased in the past year. To some degree the loss of markets for our manufacturers because of lower exports has been made up by higher orders from the Defense Department. My colleague at Brookings, Robert Lawrence, has written on this subject and demonstrated that all of this talk about deindustrialization of the United States and so on does not hold much water.

Mr. ROBERTS. You know, Mr. Chairman, we sort of take for granted that the inflow of foreign capital is caused by the deficit in the current account, but it is entirely logical or just as logical to argue that a demand for U.S. dollar assets has forced us to run a current account deficit.

To put the dollar weakness or strength in perspective, I think it is useful if we do not take 1980 as the base for the normal dollar because, if you remember, at the time the hearings then were about what we were going to do about the weak dollar.

Mr. SOLOMON. Not 1980, 1978.

Mr. ROBERTS. If you compare the dollar today with where it was in 1968, the dollar today is very weak. I remember when the dollar was traded at 4.3 deutsche marks and 4.3 Swiss francs, and if you talk about the strength or weakness of the dollar, of course it depends on the point of time you take to make your comparison.

In 1980, that was a time of very high inflation in the United States. It was a time following a long-term deterioration of the dollar. But in the sixties the dollar was twice as strong as it is today and this was a period in which we were able to compete in world markets.

Chairman GIBBONS. As an American soldier I got paid in dollars and I had to buy British pounds. I had to pay $4.04 for a British pound 40 years ago, so I realize what has happened to their currency and what has happened to ours in relationship.

Mr. ROBERTS. Theirs has deteriorated terrifically with regard to ours, but ours has deteriorated with regard to the German mark and the Swiss franc and other European currencies.

Mr. SOLOMON. It is probably useful, Mr. Chairman, to make the distinction, as economists do, between the actual exchange rate and what we call the real exchange rate. One reason why the pound is worth much less today than it was when you were there is they have had much more inflation than we have over those years.

But the reason for why the exchange rate is leading to a large trade deficit is because the real exchange rate of the United States has appreciated. That is one of the reasons, I should say.

Chairman GIBBONS. Well, as I remember, we had the dollar pegged at 330 yen to the dollar or something like that.

Mr. SOLOMON. 360, I think, for many, many years.

Chairman GIBBONS. That was for a great many years, and that pegging really had a distorting effect over a long period of time.

Well, I appreciate what you have come and said today. The sum and substance of it, if had to sum it up as I sit here now, is to make me even more cautious about legislative action in the trade field. I hope that through all of the public media that you have available to you, you will let that word get out even more than you have; because certainly politically we need to work together to keep us from making terrible mistakes that would badly injure our economy and perhaps the world economy—certainly the world economy—in this area.

So I think it has been very useful. Thank you very much.

[Whereupon, at 2:35 p.m., the subcommittee adjourned, to reconvene upon the call of the Chair.]

U.S. TRADE DEFICIT

TUESDAY, APRIL 10, 1984

House of Representatives,
Committee on Ways and Means,
Subcommittee on Trade,
Washington, DC.

The subcommittee met at 9:30 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Sam M. Gibbons (chairman of the subcommittee) presiding.

Chairman Gibbons. Good morning, ladies and gentlemen. I think everyone knows that this is a meeting of the Trade Subcommittee of the Ways and Means Committee. This morning the Trade Subcommittee has as its first witness the most important gentleman, the Honorable Paul Volcker, Chairman of the Board of Governors of the Federal Reserve System.

Following Mr. Volcker, we will have a panel of distinguished U.S. bankers.

Mr. Volcker, we appreciate your coming. You are no stranger to this room and no stranger to the Ways and Means Committee. We feel like you are a special friend. You put a lot of comments in and we need your guidance as we look at this very tough situation dealing with our trade deficit.

Mr. Volcker, you have a statement there and you may proceed as you wish.

STATEMENT OF HON. PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. Volcker. Mr. Chairman, I appreciate being here and back in this room. I do have a statement and I would be happy to read it, but I don't want to make any unwarranted assumptions if members of the committee have already reviewed it, I am willing to proceed directly to any questions or discussion you may have.

Chairman Gibbons. Well, let me ask my colleagues. I don't know whether any of them had a chance to read it. I read it last night but that is because staff brought it to me, and I found it very interesting. Perhaps you may want to hit some parts of it and then we can go right into the questions.

Mr. Volcker. Let me just make some of the basic points anyway, Mr. Chairman.

I express on page 1 the basic point that our deficits currently are linked, not exclusively but importantly, to the internal budget deficit. To restore better balance to our external accounts, consistent with a healthy and noninflationary economy at home, we cannot, in my judgment, escape the need for decisive action to deal with our internal deficit.

Policies aimed directly at the external deficit that cut against market forces—for example, import restrictions or other controls—are likely to have limited effects, at best, on the overall trade balance and would work at cross purposes to other objectives in a way that I think in the end would be counterproductive.

On the next page or two of the statement, I review the very large changes in the trade account in recent years. It is rather common now to predict, and I would accept the probability, that our trade account will be in deficit by more than $100 billion in 1984. The trade deficit has already reached about $100 billion at an annual rate in January and February of this year, which is a swing in the nonoil balance also of about $100 billion since 1980.

My statement goes on to allocate the $100 billion swing in the nonoil balance among different proximate causes. It attributes one-third to one-half of the swing to the relatively rapid growth of economic activity in the United States, together with the difficulties in Latin America and elsewhere in the developing world that have led to a large cutback in imports from the United States.

Finally, a large factor is the appreciation of the dollar in recent years. The magnitude of that appreciation is discussed in the statement. We attribute perhaps half of the deterioration in the trade deficit to the direct effects of the exchange rate.

But I would also want to emphasize, in reviewing these proximate causes of the change in trade balance, that it is really necessary to look more deeply for an explanation of why those particular developments are happening.

We have had restrained growth abroad, partly because foreign countries by and large, have been following relatively restrictive policies, attempting to deal with their own inflationary problems. I think from their viewpoint, their problems have been complicated by the high interest rates and the capital outflow to the United States.

I think the problems in the developing world are familiar. The point I would make with regard to the developing countries is that while the contraction of their imports has had a very large effect on our trade balance, we may be through the worst of that; in some of those countries their imports are again expanding, while for others that may not yet be true. But on the whole, we probably can look toward some increase in our exports to those countries, although it will be a long time before we get back to the magnitude of exports that we had a few years ago, considering the problems in those countries.

The most interesting question, in a way, of course, is what has happened to the exchange rate against a general background of economic activity in the United States. I review an analysis, which I am sure is familiar to some extent to the members of the committee, that the United States during this period has been a very attractive place to place capital, partly because our interest rates are high, but not entirely because our interest rates are high. For a variety of both economic and political reasons, the United States has been a favorite place for people in other countries to place their money in recent years. The desired net capital inflow during the period that trade balance was deteriorating has been strong enough to produce an appreciating currency.

Ordinarily with the trade balance declining, moving into large deficit, and the current account moving into large deficit, you might expect a weakening currency. We have had the opposite, because of the attractiveness of the United States for capital.

I think that brings us to the analytic point that I mentioned at the start. Part of the reason for that inflow of capital is the pressures on our financial markets and interest rates. Those pressures stem in part from the budget deficit. The budget deficit has also been a major stimulus for the economy. That combination of events has produced a high exchange rate. This in turn has encouraged imports.

In the short run, those imports, and even that exchange rate, had some salutary effects in keeping inflation down and keeping our markets very competitive, but we run into the obvious problem that, in my judgment anyway, a trade deficit of $100 billion or more and current account deficit in the neighborhood of $80 billion is simply not going to be sustainable over a period of time. We have had some benefits from that, but those benefits may not and will not be sustainable. The question, of course, is what to do about it.

Let me say that I think there is a positive and constructive way to approach the problem: a way that is consistent with maintaining and indeed reinforcing confidence in the economic prospects in the United States. That is action to reduce the budget deficit as fast and as forcefully as we can do it.

That has, it might be argued, dampening effects on the economy; but those dampening effects on the economy would be offset by lower interest rates than we would otherwise have.

I would, as strongly as I can, discourage the view that the way we can handle the problem of large external deficits is by placing restrictions on imports. It is a familiar line of argument that import restrictions will create jobs, and from the viewpoint of a particular industry, that might be the result. But the question is, what happens over all?

If, with a continuing capital inflow, we succeeded in the first instance in reducing imports, presumably the value of the dollar would be driven still higher and the effects of that would be shifted off onto other industries. There is no reason to believe that there would be a net increase in jobs from that process.

I do urge that you not yield to the very widespread demands for import protection. There are a variety of longstanding reasons why that approach will be counterproductive in terms of antagonisms abroad and retaliation abroad. I think that in terms of straight economic analysis, in terms of our own problems, it would be unfortunate at this time.

In my statement, I touch upon the question of intervention and suggest why I don't think that is a fundamental answer to our problems. I touch upon the problems of monetary policy very briefly.

One could argue that pushing interest rates lower, presumably through monetary policy, would help reduce the capital inflow and would, in turn, help the trade balance over a period of time, perhaps in part by depreciating the currency. If it does that at the expense of rising inflation, I think it would be decidedly counterproductive in terms of our long-term and fundamental economic goals in the United States. I don't think we can seek an answer or afford to seek an answer to our problems in terms of returning to inflation and the kind of problems we had a few years ago.

In sum, while I don't analyze them all in this statement, I do think there have been a great many encouraging things happening in the American economy in terms of sustaining expansion and dealing with inflation. The trade balance and its deterioration present a major challenge, obstacle, risk—however one wants to word it—for the future.

I think there are constructive ways of dealing with the trade balance that inevitably take time but that would be consistent with reinforcing the prospects for economic growth and for continuing our progress against inflation; and there are destructive ways of dealing with it.

Naturally, I urge caution with respect to the latter and restraint with respect to the latter and aggressiveness with respect to the former. This committee in its other guises is already working constructively in fixing up the budgetary situation.

Chairman GIBBONS. Let me see if I understand your analysis correctly, and I may make a mistake so don't hesitate to correct me.

One, I think you say about 50 percent of our trade deficit is due to the fact that we have such a large domestic deficit. And then that has other impacts. It tends to make our currency more valuable because we have higher interest rates. It tends to accelerate our own recovery—in effect, encourages us to import more goods. Our large deficit has discouraged the recovery of the rest of the world because we are importing so much of their capital to help pay for our deficit.

So, essentially, all this gets back to our domestic deficit. Am I oversimplifying this?

Mr. VOLCKER. I suppose I would always say that you are oversimplifying a bit, but the thrust of the argument that you are making is the one I present in this paper.

You say 50 percent due to the domestic deficit, and I think I said something like 50 percent may be due to the appreciation of the currency, in which the deficit has been an important underlying factor.

I would not quantify the effect due to the deficit, but the general thrust of your argument is a correct representation of my testimony.

Chairman GIBBONS. Now, you do not adopt the proposal that we put on an income or a tariff surcharge or a surcharge on imports, as I recall from your statement. You are not advocating that we pass any of the restrictive legislation like domestic content or steel quotas and things of that sort.

Am I correct in that?

Mr. VOLCKER. That is correct. If I may just address both of those points very briefly. You could make a conceptual, theoretical argument for an import surcharge if we were in quite a different economic situation.

If this were happening in the midst of a recession with unemployment rising, with the dollar appearing to act perversely, you could at least make the argument that that might be effective in changing the situation, despite all the other difficulties of that kind of an approach on general trade grounds.

I don't think you can make that argument now, when the economy is expanding rapidly and when the exchange rate is being propelled—if that is the right word—by a capital inflow, because under those conditions, a surcharge is not going to do anything about that capital inflow. It might incite more capital inflows. It might incite more appreciation, which works against the objective.

In terms of those more specific measures that you mention, again, against the background of an expanding economy, one has to question whether that is an appropriate economic policy, when our medium and longer range problem in those industries, among others, is making ourselves competitive—being able to compete in the United States and in world markets in industries that are very important.

But these same industries, I think, historically, have also labored under a relatively high cost structure in the United States and a relatively high wage structure, and both the steel and automobile industries, and particularly the automobile industry, have been making progress and making themselves more competitive. Specific restraints of that kind, I think, just give incentives to go in the other direction.

Chairman **Gibbons**. Have you thought at all about the so-called Japanese voluntary agreement on automobiles? Has it perhaps outlived its usefulness if it ever had any? Maybe you have not thought about it.

Mr. **Volcker**. I have thought about it a bit. Let me approach it from the side of our general economic problems.

We have had a rapid expansion in the economy for, I guess, 16 months now as technically measured. It has reached the point where in a few industries—still a limited number of industries—we are begining to see pressures on capacity, and we will have a problem of keeping further expansion reasonably in line with growth and capacity.

One of the industries where that is true at the moment—in terms of at least some car models, the models that are selling the best—is the auto industry. We are coming, I understand, at least close to areas where further sizable increases in production will become difficult. It is an industry that has had competitive problems in the past, as I mentioned, and there has been some restraint in recent years, but it is still certainly a relatively high-cost, high-wage industry by world standards.

Given all those developments, I have to raise the question whether, in the interest of sustainable economic advance and the interest of keeping inflation under control, it is wise public policy to forego the competition that we get from abroad, specifically, in this case, from Japan.

It is certainly anticompetitive to keep those controls on. Controls that started when the economy was at a low level and the automobile industry was operating at an historically low level look quite different to me in today's circumstances.

[The prepared statement follows:]

STATEMENT OF HON. PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. Chairman and members of the Subcommittee, I am pleased to have this opportunity to discuss some of the issues surrounding our large and growing trade and current account deficits. As always, the flows of trade and other payments with the rest of the world reflect a variety of forces here and abroad. A substantial disequilibrium, such as at present, can usually be traced to other difficulties and imbalances in domestic economies or economic policies. That is the case now.

To summarize my basic point, our external deficits currently are linked—not exclusively but importantly—to the internal budget deficit. To restore better balance in our external accounts consistent with a healthy and non-inflationary economy at home, we cannot, in my judgment, escape the need for decisive action to deal with our internal deficit. Policies aimed directly at the external deficit that cut against market forces—for example, import restrictions or other controls—are likely to have limited effects at best on the overall trade or current account balance or would work at cross-purposes to other objectives. In the end, I believe they would be counter-productive.

Our trade deficit reached the unprecedented magnitude of more than $60 billion last year—$75 billion at an annual rate in the fourth quarter. It is now generally expected that our merchandise imports will exceed our exports by at least $100 billion this year—already in January and February the deficit averaged more then $100 billion at an annual rate. Consistent with that trade deficit, the entire current account is likely to be in deficit by about $80 billion in 1984, or more than 2 percent of the GNP. That percentage is nearly twice as large as any U.S. historical experience since World War I.

The causes of our large external deficits can be analyzed at two different levels. The most direct approach is to explain trends in the trade balance in terms of such proximate causes as the behavior of exchange rates, the strength of economic activity at home and abroad, and relative rates of inflation. But a full explanation must look beyond those considerations to factors determining exchange rates, economic activity, and inflation. That naturally brings us to a consideration of economic policies both in the United States and abroad.

For purposes of analysis, it may be convenient to assess the change in the trade balance from a base period of late 1980 when our current account was roughly in balance. U.S. trade, during that period, was in deficit at a rate of about $25 billion. The difference reflected in large part a sizable surplus of net investment income—income built up as a result of net investment abroad over many years but which may be dwindling away in the future as a result of our heavy borrowing abroad. Indeed, available statistics suggest that the net creditor position of the United States vis-a-vis other countries—a position built up over many years—is being reversed; we will shortly be a net debtor.

The deterioration in our trade balance of roughly $75 billion since the base period took place despite a sizable reduction of about $25 billion in our imports of oil. There has been an adverse swing of about $100 billion in the "non-oil balance"—that is, the difference between our payments for non-oil imports and our export revenues. (See the table attached to my statement.) To put that figure in perspective, the entire residential building sector of the GNP that attracts much attention is some $150 billion; the change in the non-oil trade balance over little more than three years was equivalent to two-thirds the size of that whole industry. Plainly, the deterioration in our trade position has had profound effects spread through many firms in all parts of the United States. Those engaged in foreign trade or competing with imports have not shared proportionately in the strong expansion in economic activity generally, and some important industries are still operating well below 1980 levels.

One factor that has contributed importantly to the widening of the U.S. deficit has, in fact, been the relatively stronger expansion of the U.S. economy relative to foreign industrial economies. In that sense, part of the deterioration is cyclical, and does not reflect loss of markets at home or abroad but absense of proportionate gains. In addition, exports have dropped sharply to developing countries that are burdened with large external debts and are in the midst of readjusting their own economies and balance of payments. That is particularly true with respect to our neighbors in Latin America; exports to that area have dropped by $13 billion since the base period. These two factors appear to explain a third to a half of the adverse swing in the non-oil trade balance.

The third factor directly affecting our non-oil trade balance has been the dramatic appreciation of the dollar over the past three years. Starting at a relatively low level historically, the value of the dollar against the currencies of foreign industrial countries has risen about 45 percent in nominal terms since the end of 1980. Over the same period, U.S. price performance has been somewhat better than the average in foreign industrial economies; U.S. consumer prices, for instance, rose by 18 percent from the fourth quarter of 1980 through the fourth quarter of 1983, while consumer prices in the foreign industrial countries rose almost 25 percent on average. But even allowing for the differential in inflation, the dollar has appreciated substantially, and it is now roughly 25 percent higher than its average level for the entire 11-year period of floating exchange rates. Some calclations suggest more than half of the $100 billion change in the non-oil trade balance from the base period can be traced to the dollar's appreciation.

Such calculations concern only the proximate causes of the growing U.S. trade deficit. The more relevant questions concern what lay behind those developments, and what are the prospects. We know economic recovery in other industrialized countries has been quite moderate, reflecting in part relatively restrained fiscal policies—in the sense of working toward reduced government deficits. That approach has been motivated in large part out of concern about inflation, as well as the size of deficits carried over from earlier years. To some extent the depreciation of their currencies relative to the dollar—in which important import commodities are denominated—added to price pressures in those countries, and some of them probably were constrained to maintain relatively restrictive monetary as well as fiscal policies in the light of those pressures.

By now, increased exports to the United States, among other factors, have helped encourage recovery in the foreign industrial countries and expansionary momentum now appears more firmly established. Moreover, the process of adjustment in some of the deeply indebted developing countries has reached the point where some resumption of import growth appears to be developing, although imports will not reach the levels of a few years ago for some time. As a consequence, prospects for U.S. exports during the remainder of 1984 and beyond are improving, albeit moderately.

For the time being, the strength of our own expansion—which is still proceeding more rapidly than abroad—may continue to be reflected in imports growing as fast or faster than exports. In these conditions, and because imports are now so much larger than exports, significant progress in closing the trade deficit cannot be anticipated for some quarters.

At the same time, stronger growth abroad may well mean that savings in other countries will be more fully utilized at home, so that other things equal—capital will flow less freely to the United States. That could pose a problem because we are bound to be dependent upon capital inflows from abroad for some time to finance our trade and current account deficits, and those inflows are moderating pressures on our financial markets.

There can be little doubt that the ready availability of imports and the strength of the dollar—together with the related capital inflow—has had some short-run beneficial effects during the past year in support of relatively noninflationary expansion. With the huge federal deficit feeding purchasing power into the economy, domestic demand—reflected in consumption, domestic investment, and government spending—is estimated to have grown over the past five quarters at an annual rate of about 8 percent, faster than during the equivalent period of any earlier postwar recovery. Some of that demand was absorbed by imports; as a consequence, Gross National Product—a comprehensive measure of U.S. production—grew more slowly than demand. But that growth was still large, at a rate of 6½ percent over the period; and the availability of imports has been a key factor keeping inflation incheck and in avoiding strong pressures on capacity in some industries. At the same time, the capital necessary to finance the current account deficit has also increasingly supplemented the supply of domestic savings. In historical terms, interest rates have remained high in the United States; they would have been higher still had we been required to finance our domestic growth and the budget deficit from internal sources alone.

That point is illustrated in the chart attached to my statement showing the demands for, and the sources of, savings in recent years and, prospectively, in 1984. As can be seen, the combination of rising private investment and the high level of the budget deficit exceeds our savings domestically by an increasing margin. The difference is increasingly made up by savings from abroad, supplementing domestic savings this year by perhaps 25 percent, or about 2 percent of the GNP.

Whatever their benefits at the moment for the economy as a whole—and they are very real—rising trade deficits and capital inflows are not sustainable indefinitely. And, of course, those industries most exposed to foreign competition do not share in the benefits, and they increasingly demand protection. In effect, our trade problems do, in my judgment, signal deep-seated imbalances in the world economy and in economic policies.

The central thrust of my remarks is that these imbalances must be dealt with in a constructive way—by going to the source—rather than by protectionist measures. The latter are like medical tourniquets; they may sometimes seem justified to stop bleeding, but applied too long and too strongly they cripple the limb and threaten the recovery and good health of the whole body.

Many have pointed to an "over-valued" or "artificially high" dollar as a major source of the difficulty. In terms of the trade balance, the point is understandable. But the dollar is where it is because of a balance of forces in the market, reflecting capital as well as trade flows. There is not, in my judgment, evidence that the value has been manipulated, in any significant way, by our trading partners, through intervention in the exchange markets or otherwise. Instead, appreciation of the dollar over the past three years in the face of larger trade deficits reflects the strength of incentives to place capital in the United States.

While capital flows do not always closely reflect changing interest rate differentials, there can be no doubt the persistence of high real interest rates in the United States, relative to those prevailing in most other major countries contributed importantly to attracting money from abroad. That was particularly true during a pereiod when, in relative terms, political and economic confidence in the United States has been strong. In an uncertain world, many individuals and businesses in both developed and developing countries have looked upon the United States as a "safe haven" for their liquid funds and for their capital. At the same time, U.S. banks and others have curtailed their net lending abroad, in the light of stronger demands for credit in some other countries.

It cannot be in our interest to curtail capital inflows and to precipitate a fall in the dollar by taking actions that undermine confidence in our economic policies and outlook—specifically by undermining the progress against inflation or prospects for sustained growth. Moreover, as I emphasized a few moments ago, we are, for the time being, dependent on capital inflows to help finance both domestic growth and the trade deficit; neither the budgetary nor the trade deficit will end suddenly.

There is, however, a positive and constructive way to approach the problem—a way entirely consistent with maintaining and indeed reinforcing confidence in our economic outlook and our domestic needs. Specifically, forceful action to reduce the federal budget deficit would directly reduce pressures on our financial markets by restoring a better balance between domestic sources and uses of credit and capital. The restraining effects on economic activity of the lower deficits should be wholly or partially offset by lower interest rates than would otherwise prevail, and as interest rates moved lower relative to those abroad, we would be weaned from our dependence on foreign capital. In that context, prospects for foreign growth could improve, helping our exports, and exchange rates should in time reflect a better long-run competitive equilibrium. As we move to restore a sustainable international trading position, the improved trade balance will also help maintain domestic growth.

No doubt that process will proceed more unevenly, and perhaps more slowly, than we would like. But there are enormous dangers in an effort to short circuit the process through more direct measures to curtail imports or inflows of capital, both of which would work at cross-purposes with the basic requirements for growth and stability in the United States and elsewhere.

Beware, in particular, of those arguments that suggest import restrictions designed to benefit one industry or another will produce more jobs for the economy as a whole. To a particular firm or industry, shutting off import competition offers immediate advantages; more generally, it is argued that—other things equal—each reduction of a billion dollars of the trade deficit represents an added billion dollars of domestic output. Given the rule of thumb that each billion dollar's worth of domestic output requires about 25,000 workers, calculations are made that, say, cutting the trade deficit in half, or by $50 billion, would produce nearly 1-1¼ million jobs. But, from the standpoint of the whole economy, the pitfalls in such reasoning at a time when the economy is already expanding strongly should be clear.

If we should actually succeed in reducing our trade and current account deficits by means of import controls, we would also lose the capital inflow and undoubtedly experience stronger inflationary pressures. Both of those factors would tend to push interest rates higher, curtailing jobs in interest-sensitive sectors of the economy, including both homebuilding and long-term business investment. Alternatively, jobs might be created in those industries directly benefitting from the controls, but the exchange rate would be driven still higher than otherwise, hurting other import-competing industries and exporters, including farmers, and multiplying the demands for protection or subsidies. No doubt, pressed very far, there would be a mixture of effects, further complicated by retaliation abroad and international political antagonisms.

That is the case—and it seems to me overwhelming—for not yielding to generalized demands for import protection. So long as we fail to deal with the underlying causes, our action will not only be ineffective in dealing with the trade problem, but undermine the broader goal of sustained, non-inflationary growth.

The hard fact is that, even if trade restrictions could be pressed far enough to be successful in reducing our current account deficit, they would only redistribute the strains and imbalances in the economy so long as we cannot finance rising domestic investment from domestic savings. We would assist some industries at the expense of others more sensitive to interest rates, and in the process open the way for renewed inflation and undercut efforts to improve productivity and efficiency.

No doubt there may be specific instances in which trade restrictions have been, or are, justified to counter subsidies or other unfair competitive practices abroad; carefully assessed and monitored, such action can be consistent with encouraging fairer and open trading practices around the world. But there are areas where existing restrictions can no longer be justified, and run the risk of encouraging pricing and wage bargaining inconsistent with the longer-run competitive health of the industries directly affected.

Another approach that has been proposed to reduce our external deficit is to intervene in foreign exchange markets to bring about a depreciation of the dollar and subsequent improvement in our trade balance. In my judgment, exchange market intervention can occasionally play a useful role in dealing with disturbed market conditions or even in signaling the desires or policy intent of the financial authorities in various countries, particularly when the approach is coordinated among them. But its role is subsidiary; experience strongly suggests that intervention alone is a limited tool that cannot, itself, greatly or for long change the market results unless accompanied by changes in more basic policies. And if those policies are appropriate, continuing intervention on any large scale is not likely to be necessary.

In that light, some might suggest that monetary policy should be directed at bringing about lower nominal interest rates and a depreciation of the dollar by accelerating growth in money and credit. But in the United States, with the economy growing strongly and credit growth already large, such an effort would be counterproductive. It could only rekindle expectations of rising inflation, with the clear associated danger of a perverse influence on interest rates as potential lenders withhold funds because of fears of more inflation. In those circumstances, confidence could all too easily be undermined to the point that declines in the dollar would cumulate on themselves in a manner reminiscent of some earlier years, reinforcing inflationary pressures.

We have come a long way in bringing down inflation and inflationary expectations in the United States and in laying the foundations for sustained expansion. We are beginning to enjoy the fruits of that effort. But it is also clear that our trade accounts, and our external position generally, reflect basic imbalances in our economy and in our policies that must be dealt with promptly and effectively. The main direction those efforts should take is clear enough, and I can only be encouraged by the efforts of your Committee and of many others in the Congress to take steps necessary to deal with our budget deficit.

Equally important, we must avoid striking out in the wrong directions—toward renewed inflation, or toward controls and protectionism. Those paths would only encourage more instability here and abroad. We would risk substituting new, and even more intransigent, problems for those now before us—problems that were all too familiar a few years ago.

Finally, Mr. Chairman, I would like to comment briefly about the general instability of exchange rates during the past decade and more since the breakdown of the Bretton Woods system. This is not the time or place, were I capable, of reviewing all the possibilities for thoroughgoing reform of the international monetary system. But I do believe the amplitude of the swings we have seen in exchange rates over that period are excessive and potentially damaging in terms of maintaining an open world economy.

In approaching that problem, I believe we must keep in the forefront of our minds the evidence that the instability and uncertainty in international markets can in large part be traced back to instability in domestic economies and policies, and to lack of coordination in the mix of policies among countries.

With great difficulty and pain, we have made progress here and abroad in dealing with inflation, and now growth has been restored. We must, and we can, deal with the remaining imbalances in ways that contribute to those fundamental goals. As we do so—and only if we do so—we should be able to look forward to greater stability in exchange markets.

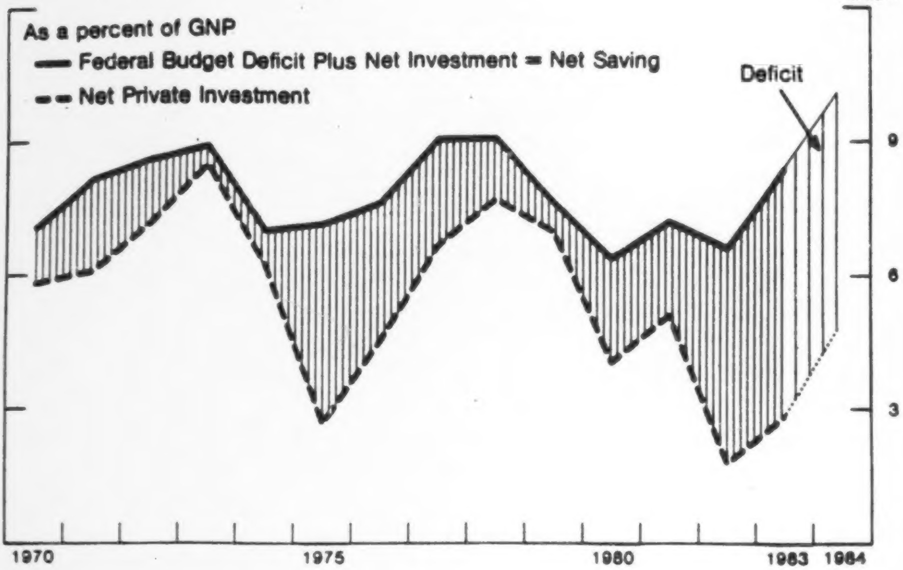
In that connection, as we develop our "mix" of economic policies in the United States, and as other countries approach their economic policy decisions, the desirability of greater stability in exchange rates seems to me to deserve real weight. More often than not, disturbances in exchange markets, and misalignments of currency values and trade balances, are symptomatic of more fundamental problems of economic policy. That seems to me to have been the case over a number of years. We should learn from that experience—and the current situation seems to me an apt case in point.

U.S. TRADE POSITION

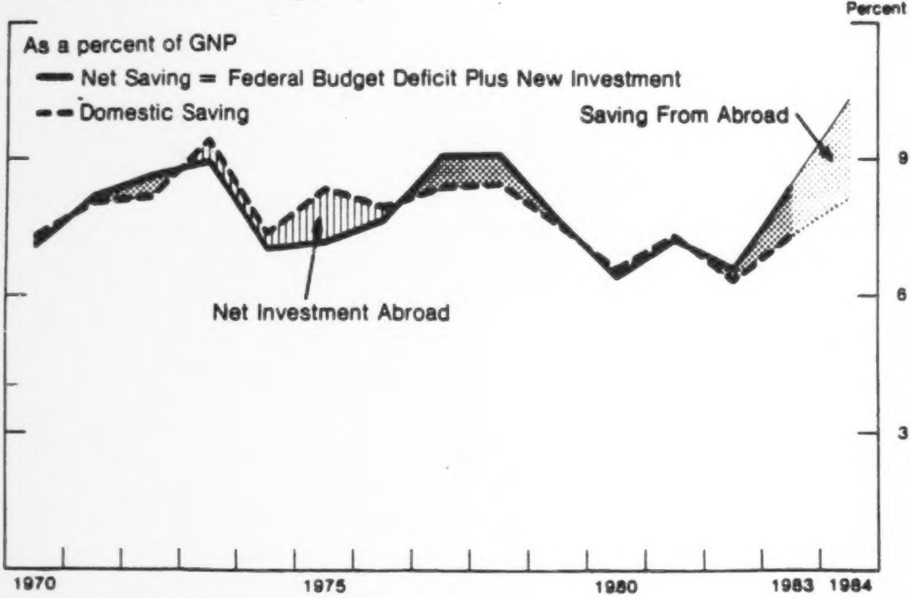
[Billions of dollars, seasonally adjusted annual rate]

	1980–84	1984–January/February	Change
Exports	231	215	−16
Of which to:			
Latin America	42	29	−13
Other developing countries	42	40	−2
Imports	252	317	65
Oil	79	53	−26
Nonoil	173	264	91
Trade balance	−21	−102	−81
Nonoil trade balance	58	−49	−107

Demands on Available Saving (Net)



Sources of Available Saving (Net)



Note: 1984 figures based on FOMC members' projections for the economy and estimates of the federal budget. Saving from abroad essentially equals the current account deficit.

Chairman **Gibbons**. Thank you, Mr. Chairman.

Mr. Jenkins.

Mr. **Jenkins**. Thank you, Mr. Chairman.

Let me follow up on that. Mr. Chairman, yesterday I visited an adjoining State to me, North Carolina, down in the textile belt in Greensboro. The textile industry now in that State as well as others, even though operating at 80 to 85 percent capacity right now, tells me if it were not operating at that capacity there would be no way whatsoever that it could compete because it is more efficient for them to operate around the clock. It was forced into the high capacity and at the same time facing imports in January and February of this year at some 30 to 40 percent greater than last year, even with the restrictions that we have in that particular industry.

You indicate in your statement that those engaged in foreign trade are competing with imports such as this industry that I described, and have not shared proportionately in the strong expansion in economic activity generally.

Now, my question is this. Obviously, that is correct whether we talk about textiles or talk about steel. But I am talking about an industry that is not the high-wage industry. They are not sharing in the economic expansion. They are coming head to head with an avalanche of increase in imports in that field.

For me to tell them that they have to ride it out without any assistance in the form of restrictions simply means, in the opinion of most of those people, that they are going to die as an industry.

I recognize your objections to import restrictions generally, but for these industries who have not participated and been a part of the economic expansion we now face, are you saying that we can't do anything or should not do anything to assist those industries who have not participated in the economic expansion?

Mr. **Volcker**. I don't want to pose as an expert on every industry in the United States. My comments are going to be fairly general.

I don't know whether the textile industry has shared proportionately or not, but my impression is that it has had a considerable recovery and that indeed it is operating currently at a fairly high rate relative to capacity. The figure I have in front of me says 89 percent for the industry generally, and that is certainly higher than it was.

That is an industry where I think the conditions are quite different from the automobile industry in terms of its cost structure; it is different relative to other industries in the United States, relative to competition.

It is also an industry that for many years, as you know, has, in the United States and elsewhere, been subject to a certain amount of protection through international agreement and otherwise.

I don't know enough about the industry to comment in detail. I don't know just what may be before the committee, but I would wonder whether the practical approach in that area, consistent with what I said earlier, would not be at least to try to stand still; that is an area which has had restraints and has restraints currently and is operating currently at a higher level than other industries.

Mr. **Jenkins**. Of course, they have lost 156,000 employees in the last 3 years.

Mr. **Volcker**. I don't know whether their capacity has gone down in recent years as has been the case in some industries, such as the steel industry. But I suppose it must come in the same general area in terms of strictures.

Let's not react to this currently, very difficult, and I think basically unsustainable, trade picture by taking a variety of actions that are really going to aggravate the situation, in my judgment, for the country as a whole, rather than help. Let's put our emphasis on things that we know are constructive.

I recognize the difficulties from where you sit. In one sense, I am saying, in terms of these particular industries, let's try to ride it out, see whether the basic situation does not improve. That is going to help all these industries, because I think the alternative is going to be counterproductive.

Mr. **Jenkins**. What is the real difference between trying to assist an industry, whether it be steel or textiles or whatever, and our support of increase in IMF to make sure we give a little protection to some of the banking institutions?

Mr. **Volcker**. I don't view that IMF legislation as basically designed for protection of the banking institutions. I think the whole tenor and philosophy of that piece of legislation is to contribute to a more open and growing international economy, an economy in which we can, in fact, move away from protectionist measures, whether on the part of the United States or other countries.

It seems to me evident that that legislation is not the answer to all problems; it contributes to a resolution of these problems in a way that, indeed, as a byproduct, may help the banks, but it helps exporters as well and, more fundamentally, it helps all of those engaged in international trade and all of us dependent upon economic growth. That is the justification for the IMF legislation, not as an aid measure for the banks.

Mr. **Jenkins**. Basically I agree, but think in the interim what we are really doing is telling some of the banks that we are going to give you some temporary help; instead of writing off the loss, we are going to subsidize and take care of that loss in the interim, so that Brazil or whoever can make their interest payments to the banks.

Mr. **Volcker**. I don't think that is a message that I got from the IMF legislation, but it is true that all these efforts, including the IMF legislation, are designed to help put the borrowing countries in a position where they can sustain their economic viability, make adjustments, and as part of that, yes, maintain interest payments, because that is part of maintaining their economic position and part of maintaining their foundation for growing in the future. But I think the motivation is from that direction rather than as direct help for the banks. I can't deny that if the process works the banks are going to benefit, too.

Mr. **Jenkins**. It is very difficult from a practical standpoint, in the political world, to justify giving some degree of help and protection to a bank that made a bad loan and not to assist an industry that is competing and has done everything possible, and yet we say to ride it out.

Mr. VOLCKER. I recognize the practical problems you have in explaining it, but I think the question is: Are we taking actions that are basically constructive and supportive of growth and stability in the future, or the reverse? Broadly, the IMF legislation falls, in my mind, in the category of supporting growth and stability; protectionist measures fall broadly in the category of undermining growth and stability.

Mr. JENKINS. Mr. Chairman, let me ask you one last question. I know my time is about up, but last week the Fed raised the discount rate to 6 percent following increases in commercial banks' prime lending rate.

Assuming that we pass roughly in the range of what the House has recently passed, what is your outlook for inflation and interest rates throughout 1984 and 1985?

Mr. VOLCKER. I think the kind of progress represented by that legislation and other pieces of legislation in reducing expenditures certainly moves in the direction of moderating some of the risks facing the economy from an overly large budgetary deficit, and so I think, in general, it improves the prospects for maintaining economic growth and the prospects for combining that with stability.

At the same time, I don't want to suggest there are any miracles in this area, and I'm aware that the kind of legislation that is being considered is phased in over a considerable period of time. It doesn't really become effective until the next fiscal year, and the impact during the first fiscal year, 1985, is fairly limited.

So, while I think it moves very clearly in a constructive direction—moves in a direction of minimizing the risks before us—of itself, particularly during this intervening period, it doesn't eliminate all the problems, to say the least, and leaves us still somewhat exposed and vulnerable to some risks.

But it moves in the direction of reducing those risks, and for that reason I welcome it greatly.

Mr. JENKINS. Thank you, Mr. Chairman.

Chairman GIBBONS. Mr. Guarini.

Mr. GUARINI. Mr. Chairman, have you been disappointed by the fact that our savings rates have not really increased in the last couple of years where we were hoping, with the big tax cuts, that we would be having a larger savings rate so that there would be more effective capital formation in our country?

Mr. VOLCKER. You say "disappointed." I suppose, in a sense, I've been disappointed, but I can't say I've been surprised.

I attached a chart to my statement of the savings rate overall. It includes not just personal savings but business savings and State and local government savings. The chart only goes back to 1970, but it reflects a reality that goes back before 1970; that is, that the savings rate at the bottom of the chart has fluctuated in a range roughly of 6.5 percent to 8.5 percent.

I'm talking about domestic savings now. That's been the range for many, many years, and I think that reflects a pretty deep-seated structural characteristic of the American economy. It is pretty hard to get out of that channel; it fluctuates up and down cyclically, but it has not had a great tendency either to rise or fall through the years.

Mr. GUARINI. Is that what we expected when we gave the big tax cut, or was there a hope that it would change?

Mr. VOLCKER. There was a hope, I think, on the part of some people that it might change more decisively. I don't think that hope was uniform.

Mr. GUARINI. Is there anything that we should do or could do to change this pattern so that we develop more capital formation? Are there any suggestions you have that would get us off this cultural problem that we have of spending as we get our paycheck?

Mr. VOLCKER. I think it is true that historically the tax system has been somewhat biased against savings and in favor of consumption. A number of actions of a selective nature have been taken to change that recently.

Some elements of the bias remain, but I would not want to overemphasize what you can do by tax changes alone. I do think our savings rate, for instance, is probably affected by the degree to which we protect people in their old age these days, and I'm not arguing against that, but the mere fact that you have support programs for people after they retire probably takes the edge off of the urge to save at the margin when people are working.

You have other rather fundamental, traditional, institutional reasons that put savings into a particular pattern—for example, the pension fund movement. We get a fair amount of savings out of State and local government sectors because it reflects State and local government pensions which may not have existed 50 years ago. That is a positive aspect of savings. But as you shove in one direction, there is some reaction in another direction. People save less themselves because they have the pension fund.

All I'm trying to suggest is that I think it is pretty hard to change an established savings rate that goes rather deeply into habits and expectations of the American people.

Mr. GUARINI. I imagine the IRA's were a step in the right direction.

Mr. VOLCKER. They were certainly an attempt to remove this bias, and we have a very large investment in IRA accounts. I think the question is how much of that investment really is new savings at the margin and how much of it is just the movement into that particular form of money that would have been saved anyway.

I don't think there can be any question, just looking at the number of IRA accounts and the total volume of IRA accounts, that the great proportion is money that would have been saved anyway; otherwise you would see more of a reflection in the overall figures. But the question is whether at the margin we are getting some additional savings. I think the jury is still out on that, but there hasn't been enough to make a very marked impact on the overall figures.

Now, in any period of a year or two, the savings figures bounce up and down. Don't forget that if you really had a permanent increase in the savings rate of 1 percent relative to the GNP, that would be a very big increase in the average level of savings over a period of time. It would be an increase of about one-sixth, not insignificant, but well within the fluctuations that you get over any 2-, 3-, or 4-year period. It is a little hard to judge what the overall effect is at this point.

Mr. GUARINI. Do you ever think we will go back to the simple days where interest rates will traditionally be two points above our inflationary rate, or are those days gone forever?

Mr. VOLCKER. I think we would see a lot more stability in interest rates, and we would probably go back to something closer to that relationship if we had a period of time of greater stability in the economy, particularly with respect to prices.

I think we have gone through a period of the past 15 and even 20 years when the whole psychology of markets and the whole psychology of the American public changed into a concern about prospects for inflation—or maybe I should say people had confidence that inflation would continue and fears that it might accelerate—because that was what had been happening for a period of time.

Once that thinking becomes ingrained, I think it affects financial and other types of behavior, and it takes, I hope not an equally long time, but some time to get back into a more stable relationship and to develop confidence that such a relationship will continue into the future.

I hope we are going through that process now, but, quite clearly, we are not all the way through it.

Mr. GUARINI. Well, all the discussion is about inflation, it seems these days. Do you see on the world scene any strong deflationary tendencies or a scenario that we could almost go to the other extreme with the world debtor nations and third nations being in the state that they are in?

Mr. VOLCKER. I don't see strong deflationary tendencies in the sense that I think you mean in developments in the United States and other industrialized countries or indeed, in the developing world where the problem has been inflation.

But if you ask me the same question in slightly different words, "Can you imagine even a series of events that could create that risk," I think my answer would be, yes. You touched upon one area that I would have to mention; the world financial system and the world financial markets have been under some strain and pressure. If they are not adequately managed—and I think we can adequately manage them—it could undermine both confidence and the stability of institutions to such an extent that the kind of risk you mention would not be so far removed.

I think there are some contingencies out there, even though I do not see that tendency at work at all in markets or economies today.

Mr. GUARINI. Well, do you find that the IMF policies toward debtor nations has been properly effective, or has it been counterproductive to the best interests of the United States? Should there be different mechanisms in these policies?

Mr. VOLCKER. I think basically, in an imperfect world and with all the difficulties that they have to work with, the broad thrust of their policies has been in the interest of the United States and in the interest, indeed, of the developing countries themselves.

Many of these countries were on a path that was simply not sustainable in and of itself and was particularly not sustainable in a world that was not inflating at an accelerating rate of speed. They were able to sustain their policies for quite a period of time, partly because the world was inflating, which was not a healthy thing. When that environment changed, it precipitated the need for changes in their policies and adjustments in their external positions that I think would have come sooner or later anyway.

The particular timing was certainly affected by developments in the world economy and developments with respect to interest rates, but that adjustment had to be made. It is a painful period of austerity for many of these countries, but I think the object of the exercise is to build a base for renewed growth. Indeed, we can now see in at least a few countries—not very many so far—but in some important countries, that that base is, in fact, being laid and those countries are now looking ahead to prospects for more growth, and for growth that can be sustained.

In other countries, they are not to that point yet. They are still in midstream or early in the adjustment process.

Mr. GUARINI. Even in the short run, it cuts back on our trade because policies are restrictive in trying to establish the stability of debtor nations.

Mr. VOLCKER. In the short run, it has had very adverse consequences for our trade, but part of that trade was built on an unsustainable assumption that these countries could run large and growing deficits indefinitely.

The happy news on that front is that, by and large, with respect to Latin America, I think we have now absorbed the contractionary phase in terms of our exports and in terms of their imports. Overall, we would expect an increase in imports by Latin America, looking ahead. That may not be true of every country, but I think, by and large, it will be true for developing countries as a group, and it will be true for most industrial countries, as well.

We have gone through a period of 2 to 3 years when there has been an extremely sharp contraction. I am not suggesting that the improvement will be nearly as rapid as the contraction, but I do think we probably have passed or are passing the point of downward slide, and we can begin looking forward to some improvement.

Mr. GUARINI. The bell curve looks better in the future. We have gotten past the waste.

Mr. VOLCKER. That is correct. I don't think that bell curve is going to have the same slope on the upside. It is going to be a malformed bell, but I think it will be moving in that direction.

Mr. GUARINI. Thank you very much.

Thank you, Mr. Chairman.

Chairman GIBBONS. Mr. Frenzel.

Mr. FRENZEL. Thank you, Mr. Chairman.

Chairman Volcker, we appreciate your good counsel this morning. Most of the other witnesses that have so far come before this committee have suggested that the first duty of the Congress, if it wants to reduce the trade deficit, is to reduce our budget deficit. I take it that that is your primary instruction to us also?

Mr. VOLCKER. Yes, sir.

Mr. FRENZEL. And with respect to what Congress is doing this year, that is the 150 more or less, hopefully more, 3-year budget deficit reduction package, is it your opinion that that is a significant down payment, or is it something that will not have a great effect in the short run?

Mr. **Volcker**. My answer to both questions is yes. I think it is a significant action. It begins to turn that ominous curve of the Federal deficits in the right direction over a period of time.

I don't think it completes the program, but deficits feed upon themselves through the interest rates, as you know, and as we begin pulling them down, we begin, hopefully, setting up a series of events that will feed upon themselves in a more favorable direction. And, if there is a carrythrough on that program, it becomes very significant by 1987. It begins to become significant in 1986. But to answer the other part of your question, it starts out rather slowly in 1985, which is still quite a few months off. So I don't want to suggest that you necessarily get dramatic effects on the economy in the short run, but I think it is a highly constructive and reassuring action for the future.

Mr. **Frenzel**. You at one time set a standard of $50 billion as being a good target. You still think that is a better target than $25 billion in the first year.

Mr. **Volcker**. That is a nice round number, and it gets to the point where you begin having, I think, a more noticeable impact. It is obviously an arbitrary number, but given where we are starting from, I certainly don't think $50 billion is too much.

Mr. **Frenzel**. The second perhaps common denominator that comes through to us, particularly from business interests, is that we should proceed more vigorously toward what is, I guess, generally described as internationalizing the yen. If—first of all, is that a totally worthy objective, and, second, are we moving in that direction very vigorously now?

Mr. **Volcker**. I certainly think it is an objective that broadly is in line with more competitive, more open markets in the financial world, as well as in the world of goods and services. I think at this particular time, if you get a decided change in that direction, it could have more immediate beneficial results in terms of the value of the yen.

In general, I think, yes, it is a worthy objective, and I do indeed think the administration has been pressing in that direction.

I don't think it is a magic elixir for solving all our problems. Fluid and flexible international markets sometimes create problems as well as advantages. But philosophically, I think it moves in the right direction.

I think it is something that has been coming about through its own momentum to a considerable extent. I think it will continue to do so.

Mr. **Frenzel**. May I assume that you think that goal is being achieved at a swift enough rate?

Mr. **Volcker**. There are those who would certainly feel that it was not being achieved at a swift enough rate, and that it could go faster, but on the relative scale of priorities that we have, I don't think it is our No. 1 problem.

Mr. **Frenzel**. The next thing that at least our business advisers tell us that we need to do to work on the trade deficit is a list of the Government assists to trade, some of which are not cost items but a number of which, like Exim and Foreign Commerce Service, et cetera, are, which tend to conflict with the first instructions that are given.

Do you have a feeling on those cost items? Should they wait for the future, or if they are calculated to improve exports, should we continue spending at the same rate?

Mr. **Volcker**. I think some of those issues, Exim in particular, are a complement to certain trade issues that you face. In an ideal world, we and other countries would not be heavily funding export credit agencies in a kind of effort to compete with each other for a given market. We would all be better off if we all retreated and let there be a bit more market competition rather than intergovernmental competition.

But, in practice, it is rather common in this world—even if you want to work away from it—that the best strategy may be to be sufficiently aggressive in the short run so that other countries do not see net benefits to them from continuing an aggressive posture on their part.

Those are difficult judgments to arrive at, but I'm not ready to say we should retreat, particularly given our general trade position, from this kind of support of exports at this particular point in time, although I would be delighted to see a more general international agreement that made it less expensive for all of us.

Mr. **Frenzel**. If one looks at your savings chart, doesn't that mean that we are going to be behind or, rather, disadvantaged, in markets by countries, like everybody else, which have a higher savings rate and therefore are likely to have lower interest rates in general?

Mr. **Volcker**. All other things equal, I think that that is true. If the higher savings rate is reflected in lower interest rates, more favorable capital market conditions, more incentives to investment abroad, it would have some tendency in that direction. But there are many other factors working, and I would not be concerned—as far as the long-term equilibrium that we are fond of talking about, even if it never arrives—that a difference in the savings rate between the United States and other countries would permanently undermine our trade position.

We have other advantages. We have, I hope, leadership still in certain technological areas so very important in trade. We have a highly productive, agricultural sector that manages to stay in the forefront of world trade. That can be true of other industries as well, in the context of the kind of savings rate that we have.

Mr. **Frenzel**. Thank you.

Some of our other advisers have suggested that we increase tariffs, have some import surcharge, and a number of them are suggesting quotas particularly in certain areas that they perceive are distressed.

On page 10 of your testimony, you say that the case is overwhelming that we should not yield to demands for import protection, because they will redistribute the strains, so long as we can finance rising domestic investments from domestic savings. Can you expand on that a little bit?

Mr. **Volcker**. I was trying to say that those kinds of measures that you describe don't go to the fundamental causes of our problem, and as long as we don't go to those causes, I think the net result will be to redistribute the pain in a somewhat different direction.

To put it very simply, we have become dependent upon a capital inflow from abroad because the combination of our budget deficit and our expanding domestic needs are outrunning that rather stable savings rate.

If that is true, one of two things is going to happen—or some combination of the two. That puts upward pressures on interest rates in the United States, as it has, and it tends to draw in capital from abroad directly, through the pull of those higher interest rates.

Even if you were successful in reducing the trade deficit by brute strength—by controls, by quotas, by tariffs, by whatever measure you are proposing—if the desired capital inflow continued I would suspect that the net effect would be to put even more upward pressure on the exchange rate. That would feed back on the same or other sectors of the economy that produce tradeable goods and would undercut the intent of the selective pressure in the first place. There is nothing in those particular measures that goes to the root of the problem, which is an excess demand for savings in the United States—more demand than the supply we are generating domestically.

There is no way to change that by fiddling around with the trade account.

Mr. **Frenzel**. Getting back to the dollar relationship with other currencies, which you cite as the third major factor that affects the trade balance, we have had suggestions that run all over the place. Most common is to accelerate intervention. The second most common, I suppose, is that we should retreat back into a new Bretton Woods system.

I take it from your testimony on page 13 that you believe that if we manage our domestic, fiscal, and monetary policies properly, there really should be no need for a fixed system, providing, of course, that our allies and trading partners do the same.

On the other hand, we haven't seen a lot of periods in history where they have done the same, but I take it that you still are not strong for intervention, except in spot circumstances, and that you would prefer not to renegotiate Bretton Woods; is that correct?

Mr. **Volcker**. I wouldn't go quite as far as your interpretation of my remarks. I'm not opposed to intervention in appropriate circumstances, but, again, I do not see intervention as a fundamental answer to the dilemma that I just described.

Intervention is a way of trying to export some capital, in effect, through the Government, but what we have to affect is the net capital flow and the question is whether that would affect the net flow.

I don't think intervention will do so in an important way unless policies are changed, and in this case I think it is apparent in what direction the underlying policies should be changed. Intervention can sometimes play a useful supplementary role, but I just don't think it is the answer to the kind of trade deficit that we have now or that, in itself, it is going to change the exchange rate drastically if you don't work on any other policies.

As far as the longer term reform issue is concerned, I am saying that I don't think that would be a successful or a fruitful area of activity if we are not determined and do not succeed in getting a little bit more stability at home; you can say the same thing for other countries. But I don't want to dismiss entirely the possibility of looking at areas in the international monetary system where useful changes might be made. This is a little bit of a chicken and egg proposition.

It is easy for me to say, and I think it is also correct, that stability in the international system is going to grow out of stability domestically, but that does not exclude the possibility that you can get an international system that tends to encourage more stability domestically; you can get, hopefully, a benign interaction between the two.

I don't want to say that the rather unstructured system, to say the least, that we have internationally today is the ideal monetary system for all times, but I do think it would be rather fruitless to work on international monetary reform without recognizing that so much of the international instability that we have experienced has grown out of a heritage of domestic instability.

Mr. **Frenzel**. Thank you very much, Mr. Chairman.

Chairman **Gibbons**. Mr. Pease.

Mr. **Pease**. Thanks, Mr. Chairman.

Mr. Chairman, we are very happy to have you here today. We are talking about the fact that the strong U.S. dollar overseas is causing some problems, and the differential in interest rates between that offered in the United States and overseas is causing some problems.

Last week, we received testimony from Fred Bergsten of the Institute for International Economics. He suggested the possibility of an interest equalization tax that might be imposed at our suggestion or without acquiescence by the European nations and by Japan to curb their capital outflows. This would be a way of bringing the dollar into a somewhat more realistic range of its value vis-a-vis other currencies.

In your testimony, you warned us not to curb capital inflows too much. Can you comment on Mr. Bergsten's suggestion?

Mr. **Volcker**. I can comment at two levels. I think it is of doubtful realism to suggest that some approach along the lines of an interest equalization tax coordinated among many countries is really going to be effective in curbing capital flows in an orderly way. Sometimes those things tend to incite more flows than they deal with.

But, assuming it were successful and capital flows were rather abruptly curtailed at a time when, as I see the picture, we are dependent upon having a certain amount of capital flows—because our trade deficit and our current account deficit aren't going to change very suddenly—what you would be doing, I think, is attempting—presumably that is the intent—to wrench the exchange rate in a way that would feed back very rapidly into inflationary pressures in the United States. It would feed back over a longer period of time into an improved trade balance, which would be the object of the game, at a time when the economy is already expanding rather rapidly and when some industries, at least, are approaching capacity pressures and at a time when the budgetary deficit has not been dealt with.

You would bottle up those demands for capital within the United States and at the same time increase inflationary pressures within the United States. That doesn't sound to me like much of a recipe for moderate interest rates and orderly growth in the United States. It could be destructive of what we are trying to do in terms of laying the groundwork for continuing growth and price stability.

Mr. PEASE. That being the case, is there anything specific whatsoever that you would recommend that Congress or the administration attempt to do, other than reducing Federal deficits, to deal with a trade imbalance?

Mr. VOLCKER. I certainly come back to the deficits as the key, underlying problem. I really am not, I think, capable of commenting competently on many of the more particular issues that necessarily come before the committee. I am speaking in general terms.

The details of trade legislation, the details of the countervailing duty or antidumping legislation, for instance—whether those definitions should be changed or improved—are, I understand, under debate currently.

Those kinds of questions always arise, partly out of the basic concern about fairness of trade, partly out of concern about effective negotiations with other countries over a period of time, and whether we have adequate flexibility and leverage.

We have problems, such as the issue raised earlier about the openness of capital markets and money markets in other countries. I don't know of anything particular that requires legislation, but I don't exclude that kind of question.

My basic answer, I think, does come back to the primacy of the deficit, but there may be many more particular issues that need examination currently.

Mr. PEASE. Let me probe a little bit on reducing the deficits both with regard to the means of doing so and the timing. The means of reducing the deficit involve the obvious things. We can reduce domestic spending, we can reduce or at least slow down military spending, or we can raise revenue. In terms of effectiveness, does it make any difference which of those three means is implied?

Mr. VOLCKER. My general answer to that is that, viewing it strictly as an economist or as a central banker—which I don't think is the whole world, and I don't want to substitute my viewpoint with all the considerations you have to take into account—from the standpoint of the economic performance of the economy, from the investment standpoint, from the trade standpoint, the more you can do in reducing expenditures and keeping the tax burden light, the better the economy is going to operate.

I think when you put that consideration, which I think is a valid and important consideration, into context with all the other considerations you have to take into account, you may well arrive at the conclusion that you can't do it all on the spending side; and, faced with the need for reducing the deficit or doing nothing on the revenue side, I would say yes, do something on the revenue side.

That brings you to a question of what to do on the revenue side, which gets me even further afield from my particular responsibilities. In general terms, again, it is easy for me to say do as much as you can, as long as it does not damage the incentives that you necessarily deal with when you deal with the tax side of the equation.

Mr. **Pease**. Looking for a moment at the spending side, from the viewpoint of an economist, is there any difference between reducing military spending or reducing domestic spending in terms of its effect?

Mr. **Volcker**. At the first level of generality, I think I would say no. At the second level of generality, it would depend upon circumstances.

One could imagine, on the one hand, that the defense industry generally—it is a big industry and hard to generalize—may be subject in some circumstances to particular inflationary pressures, to particular capacity constraints, in a way that forcing additional Government spending would run more than the usual risk of adding to cost pressures in the economy. That is one possibility.

On the other hand, there may be areas in the defense industries that might have, over a period of time, favorable spinoffs in terms of productivity, technological changes, and all the rest. However, I think those kinds of things are of second order importance in terms of the shortrun effect and the answer to your question, as I interpret it.

In the first instance, a dollar is a dollar, and it is adding to demand in the economy, adding to the financing needs of the Federal Government.

Mr. **Pease**. Let me now turn to a distinction on the revenue side. Bearing in mind the comment you just made that it would be best on the revenue side not to tamper with incentives like ACRS and so on, do you think, from the viewpoint of an economist, whether it makes any difference whether the revenue would be raised by increasing or raising tax rates for corporations or through what could be called tax reform by reducing some of the exemptions and credits in the current Tax Code?

Mr. **Volcker**. I should probably say, it all depends and stop there, because you really draw me into areas in which it would be difficult for me to comment on specifics.

I do think that increasing tax rates in general has adverse effects on incentives. Of course, when we do that within the context of our tax system, it has very uneven effects, because of the number of special provisions in the Tax Code that wouldn't be affected. And you affect the value of with all those special provisions when you change the marginal rates for somebody else.

In general, I will make the wise observation that lower tax rates are better than higher tax rates in terms of performance of the economy, and I would not say that every special incentive is necessarily untouchable, just as a matter of principal. Some of them may go too far and may give rise to distortions and imbalances and should be reexamined, but to the extent they have a legitimate purpose in enhancing productivity or investment, there is something to be said for them.

I'm afraid that is not a very helpful comment.

Mr. **Pease**. Perhaps you put your finger on the key, that is, to examine incentives to see whether they really are appropriate or not.

As we look at the revenue picture, you say that increasing marginal rates of taxation would be a disincentive, and I think that it is understandable.

Certainly I think we would not want to deal with ACRS and other direct incentives for investment, but most of what are called tax loopholes were installed at one point or another in the name of providing incentives for economic growth for housing or whatever else.

So that doesn't leave us many areas in the revenue raising field that don't qualify as reducing incentives.

Mr. VOLCKER. Again, I would not say every one of those particular provisions in the Tax Code is necessarily sacrosanct, but I don't want to make any judgments about particular provisions. That is simply not my area.

Mr. PEASE. When the Federal Government runs large deficits and has to borrow money to finance those deficits, it is withdrawing money from the economy. If the Federal Government raises taxes, it is also withdrawing money from the economy. Some people suggest there is no real difference whether you do it by deficits or whether you do it by increasing taxes. Would you agree with that?

Mr. VOLCKER. No; I think it depends on what kind of taxes. I think there is a broad difference between, on the one hand, taking money out of the consumer income stream and achieving a lower government deficit or even a balanced budget that does not put the Government into competition with private borrowers in the capital markets or on the other hand not taking money out of the private income stream and out of consumption, thereby forcing the Government to borrow in competition with other demanders of credit.

You are likely to get higher interest rates out of the latter, and I think that does make a difference in economic performance both potentially, in the level of economic activity, and certainly, in the composition.

Mr. PEASE. Borrowing the money then, I gather you would say, would tend to be more inflationary than getting the money from taxes and also tend to run up the interest rates which would inhibit investment.

Mr. VOLCKER. I certainly think it tends to run up the interest rates. Whether it is more inflationary or not in the end depends, I suppose, upon what the Federal Reserve does.

The tendency is to push up interest rates and create pressures for more money creation, which would be inflationary. Those pressures can be resisted, but what you have then is pressures coming out in other directions. We have seen these pressures come out in the trade deficits that are the subject of this hearing this morning. I don't think that was entirely expected when all this debate took place.

There was a lot of talk about pressures on capital markets, on interest rates, that it might affect housing. In fact, housing has done pretty well during this period, but we see the pressure in another direction, on the trade side. The trade side, I suppose, doesn't get the attention that the housing industry would have gotten if it had a similar kind of collapse, because we are used to thinking of the housing industry as an industry.

The trade balance affects the whole variety of industries over the country. This decline in our trade balance, as I mentioned in my testimony, has been two-thirds the size of the whole housing industry.

Suppose housing construction went from $150 billion to $50 billion. That is what happened in the trade area, in effect, where we have had a $100 billion swing in our nonoil trade deficit. I suspect there would be a lot of concern if our housing industry suddenly shrunk by two-thirds—by an amount comparable to what has occurred in the trade areas.

Mr. **Pease**. Let me ask you quickly about the timing of deficit reduction. We hear a lot of talk about a downpayment this year, which suggests that the main payment is going to come in 1985 or beyond. Clearly, there is a political gain for the President, and Congress, for that matter, in delaying the painful deficit reduction decisions until after November 1984.

How much of a risk do we run by delaying our genuine efforts or primary efforts until after the election?

Mr. **Volcker**. I have been trying my best to urge that it not be delayed, precisely because I think you run very substantial risks. Those risks are ameliorated to some extent by carrying through on what is under discussion in this committee and in the House and in the Senate, but it doesn't eliminate the risks because it has a fairly long fuse. Looked at in the longer perspective, I think the word "downpayment" is an appropriate characterization.

I think the way to describe it is as a risk. I don't think anyone can sit here and tell you that if nothing were done between now and 1985, that this or that or the other thing would inevitably happen. I think it is more in the nature of risk appraisal; clearly one of those risks is that interest rates will rise instead of remaining stable or falling.

What is the nature of that risk? There is risk to the housing industry. There is risk to investment. The more acute risk, in a sense, is whether that undermines the financial health of two important areas of the American or world economy in a more abrupt way.

I am thinking of the whole thrift industry, which only recently has had a little glow of health in its cheeks as interest rates fell; the strain is still apparent, and the prospects for improvement would be set back by a decided increase in interest rates.

An increase in interest rates would also run directly against the efforts that are being made to keep the international financial strains and debt situation manageable and under control. There is nothing that would feed back more rapidly in terms of aggravating that problem than a decided increase in interest rates.

Mr. **Pease**. Last question. My worst-case scenario, the scenario that gives me nightmares, is that the high deficits and the delay by the President and the Congress in dealing with those deficits will lead to higher interest rates, inhibiting investment and will lead to inflation, which in turn will cause the Federal Reserve Board, through its credit policies, to try to inhibit those increases. All of this will contribute to a slowdown in the economy, to triggering sooner than it would otherwise the next recession. This recession will come prior to the time when Congress has gotten around to increasing taxes or cutting spending in order to reduce deficits so that we will be unable in the period of the next recession to either increase taxes or inhibit the growth of spending for unemployment compensation and so on. The current deficits of $200 to $250 billion a year will look more like $300 to $400 billion a year with approximately no ability on our part to do anything about it.

What chance do you see of that risk coming to fruition?

Mr. VOLCKER. I may judge the risks slightly differently than you, but that is one way to put the dilemma, and it is created by these large deficits.

In the early part of your question, you made some allusion to what the Federal Reserve might do. I can assure you under those circumstances the Federal Reserve has no good choice, but if you were left with the choice of inflating or not inflating, I think you can correctly assess our inclination.

But why should we be left in this kind of dilemma whereby, following a noninflationary policy, after all the progress that we have made in that direction, we should be put in a position where we jeopardize the future stability of the economy?

The answer is obvious, it seems to me; deal with the source of the difficulty.

I thought you might put another area of concern in your nightmare; that is, what would happen if the international climate changed in a way that this capital inflow, which has the effect of moderating those pressures on internal markets, should turn in the other direction through a lack of confidence. I would say it would turn in the other direction if the view became prevalent that we face the kind of inflationary threat, the instability, that you foresee, and the result of that would be to aggravate the inflationary situation and to aggravate the pressures on the money market at the same time.

What could we do about it through the tools at our command? I don't think it is a problem which would be easily amenable to any monetary policy reaction, and I will add that to your nightmare. I think that is what we want to avoid happening.

Look at this a bit more constructively. I don't want to minimize for a moment the strength of our position, the progress that we have made. But it is obviously flawed. The two flaws that stand out so clearly are the trade deficit and current account deficit and their almost mirror image in the budgetary deficit.

The numbers are so big that commonsense probably tells you that there is some connection between those two phenomena when we are so far off course in both directions. And, in fact, what I am trying to say is that that is what economic analysis tells you; there is indeed some connection between those two phenomena.

Mr. PEASE. Thank you very much, Mr. Chairman. This has been very helpful testimony.

Chairman GIBBONS. Mr. Crane.

Mr. CRANE. Thank you, Mr. Chairman.

Chairman Volcker, I first want to applaud your recommendation to move circumspectly with regard to any effort at protectionism as a means of addressing this problem and I applaud you for putting paramount emphasis in trying to solve the problem on the question of our budget deficit.

Mr. Pease took one of my first questions, and that was the question of whether it is better to take it out of the pool of earnings or whether to take it through savings, direct it into investment in interest-bearing notes.

While I agree with you if you are talking exclusively about the U.S. market, isn't it more advantageous to borrow the money when you can attract vast sums from abroad to help finance that debt rather than taking it exclusively out of the hides of the American people?

Mr. VOLCKER. I think, given the situation that we are in with the deficit, with the rising investment and with the rising economy generally in the United States, there are clear advantages of borrowing money abroad. That is what we are doing, and it enables us to kind of reconcile our domestic objectives. We can have growth and we can do it in the context of less inflation in this situation, and with lower interest rates. That is all fine as far as it goes, but it is too good to last.

That is the problem we are facing. So far it has worked; maybe it will work for another year; maybe it will work for another 2 years. But we cannot assume that we can continue to run a $100 billion or more deficit indefinitely. We cannot assume that others are going to have the incentive to invest in the United States and make their money available to us indefinitely. In fact, it seems to me rather obvious that deficits of that magnitude carry the seeds of their own destruction.

If you keep piling up an international deficit of this magnitude, at some point confidence will disappear. The only reasonable question, I think, is how we deal with and prepare for that development that is going to happen sooner or later. We can do it constructively or we can do it destructively.

Mr. CRANE. Mr. Chairman, which, in your estimation, is the better way to promote domestic growth: by reducing personal taxes, personal business taxes or by reducing interest rates, or is there some happy balance between the two that is the ideal?

Mr. VOLCKER. I suppose there is some happy balance between the two. Looking at where we are right now and at the level of interest rates that we have, the deficits that we have, it seems to me you only gave me the option of reducing taxes.

Mr. CRANE. Reducing taxes or lowering interest rates or trying to find a balance.

Mr. VOLCKER. I want to put into that equation reducing Government spending, too, which would be, economically, the best thing to do. But if I had a choice now between reducing taxes and saying I will take a further increase in the deficit—putting the pressures on the money market now in exchange for the benefit of reducing taxes—I would not take that option.

Mr. CRANE. Well, Mr. Chairman, what I meant was if you are looking in terms of trying to promote growth, which is the better avenue to pursue, having interest rates down in a 3- to 5-percent range or substantially reducing taxes and trying to build enormous incentives for people to get out and work and earn a buck.

Mr. VOLCKER. You give me a theoretical question and I have to answer that it would all depend upon the circumstances at the time, whether you are starting with a big deficit or not.

In today's circumstances, if I want to promote sustainable growth of the U.S. economy, I do not think it would be fruitful to reduce taxes right now.

Mr. CRANE. Mr. Chairman, if that is the case, why has the Fed pursued so successfully, and I think laudatory, a policy of in practice reducing taxes, at least indirect taxes, by getting those inflation rates down from the dizzying heights they were?

The Fed's policy, I think, has been a commendable one and you have in fact done more to reduce taxes by getting the inflation rate down than any other single action taken by our National Government. I think it is the most outstanding achievement probably historically in going from the levels of the inflation rates that we were at recently to where we are.

That, in effect, is tax relief as the method of trying to restore some stability to our economy and I think you have accomplished that.

Mr. VOLCKER. I don't know what you mean by reducing taxes. In some sense, the inflation tax that we all pay indirectly has been reduced. In some sense, total revenues have been reduced because the inflation rate came down—that may be what you are referring to.

Mr. CRANE. Well, what I mean is when we have, say, an annual rate of inflation in double-digit figures, that is a tax. And I mean our dollar today is worth about 30 cents of the 1967 dollar. So that has been a pretty substantial tax, not only of my earnings but my savings, my insurance, my pension and so forth, and I think you are to be saluted for the success that you have had in getting us down into a 3-percent range of inflation.

To me that has been a policy for all practical purposes of reducing taxes as a way of going after our domestic economic problems and I think it is a proper approach, quite frankly.

Mr. VOLCKER. You are not going to find me on the side of not reducing that hidden inflation tax. I think we ought to reduce it, but I don't think that is the way I interpreted your earlier question.

Let me try again. In terms of explicit taxes imposed by this committee and the Congress, does it help growth to reduce taxes in general? It is hard to answer that question in a vacuum, but, yes, I would rather have lower taxes than higher taxes, all other things being equal.

But would I like to have lower taxes in every conceivable circumstance, including the circumstance in which we start with an already high deficit and high interest rates that have adverse consequences on the trade balance, on our trading partners, on some of our own industries? No; faced with that tradeoff, I would rather maintain the tax rates because of the budgetary constraint and try to get some interest rate relief.

I would have a better answer for you if you permit me to reduce spending.

Mr. CRANE. Mr. Chairman, in that context, here we have this dramatic success story and it is attributable to you, as I say, more than any other single thing with respect to controlling inflation, and yet real interest rates are probably at all-time high.

Now, are the banks charging these unprecedented real interest rates today because they have inflation fears looking to the future or are they doing it to cover past mistakes?

Mr. VOLCKER. Neither; I think inflationary expectations are important in the interest rate picture, but not so much the banker's expectations, because he is a middleman. He is borrowing money on the one side and trying to cover those costs on the other side with the interest rates that he charges. Much of it is on a floating rate basis.

But if you ask me whether the people depositing money in the banks are a little less eager to deposit that money at a given interest rate because of their own historic experience with inflation and their fears for the future, I think that is a factor in keeping interest rates up, and it gets transmitted through to the bank borrower through the mechanism of the bank being a middleman.

In a more general sense, then, I think I would answer your question yes. Those inflationary expectations are one factor, but it is not particularly because of the attitude of bankers but because of the attitude of everybody.

And that is only one factor. I think the deficit is another factor.

Mr. CRANE. Mr. Chairman, I have had legislation in for some years that unfortunately can't get a hearing, but it would exempt interest, dividends, capital gains, and so forth from any taxation on the grounds that the first time you earned it you got taxed on it.

If you spent it for instant gratification, you were only taxed on it once. But if you delay your gratification, you get hit twice. Considering all of the social value of encouraging savings, which we have discouraged for half a century in this country while encouraging spending and indebtedness, that kind of legislation makes sense to me and I think would have a staggering impact on interest rates and creating the capital pull for economic growth.

The Japanese have those massive percentages of personal income that go into savings in part because they do not, for all practical purposes, tax interest.

Would you favor that kind of legislation as a means of trying to stimulate savings?

Mr. VOLCKER. Let me say the point that you just made is broadly what I had in mind when I said earlier that I think there is a basic bias in the tax system against savings relative to consumption; double-taxation of savings is one aspect of that.

I don't want to make a judgment, specifically, on that piece of legislation, because it seems to me the kind of thing that ought to be considered as part of a major restructuring of the tax system, which would involve a lot of other considerations. That is an important one, but whether in the end that is a centerpiece of the reform involves enough other considerations that I just don't want to endorse that approach. I would say I think it is a very relevant consideration.

Do we want to go toward a consumption tax, which is basically what you are saying? I have a lot of sympathy toward going toward a more consumption-oriented tax at the very least.

Mr. CRANE. Mr. Chairman, you mentioned in your statement that you could not find any significant evidence at least to currency manipulation by our major trading partners. In the current issue of U.S. News and World Report, Mr. Iacocca makes that specific allegation against the Japanese and claims it causes a $1000 differential in the price of a Toyota that he is competing against.

Have you any evidence to suggest that Mr. Iacocca's charges against the Japanese have validity?

Mr. VOLCKER. No, I have not seen that article, but I see no evidence for any significant manipulation, in any sense that I would use the term manipulation, in the Japanese behavior in exchange markets for some period of time.

I am not addressing the question of trade restraints. I am not addressing the question that arose earlier of the basic approach and structure of the Japanese toward international capital flows.

Indeed, they have been liberalizing in that direction. But there is a very real question whether they have been liberalizing as fast and as aggressively as they should be. But that is not a change in a manipulating sense.

Mr. CRANE. Well, Mr. Iacocca's charge, and it goes to your point about capital flows do not always closely reflect changing interest rate differentials, that frequently they do, and Mr. Iacocca's charge is that the ratio of the yen to the dollar has remained constant whether we were financing debt at 8 percent or whether our prime went to 21½ or whether the prime is down to 11 or 12 today.

There seems to be a constancy in the disparity between the yen and the dollar. And on the basis of that, his contention is that there has been obvious intervention by the Japanese Government to preserve those ratios.

Mr. VOLCKER. One thing I am sure of is there has not been obvious intervention or I would have seen it.

Mr. CRANE. Very good.

Just one final question, Mr. Chairman. I saw a report that is disturbing to an extreme and it goes back, I think, to some of the questions raised about the potential reemergence of inflation, which is, I know, something that is worrisome to you and to all of us.

But the report I saw said that if we balanced our budgets, from now until the year 2000, we had balanced budgets, no more deficits aggravating our national debt, and we take the national debt at $1.5 trillion and assume you could finance that between now and the year 2000 at 10-percent interest rates only—both of these are highly unlikely assumptions—but if you did that, by the year 2000, our conventional national debt with compounded interest will reach $7.5 trillion and it will require over $750 billion annually to finance it at the 10-percent rate.

Now, given that rosy scenario, do you see any conceivable way that this country can reach the year 2000 without resorting to such destruction in currency? Because that is the ultimate tool when you can't even attract capital. It is just not there. If it is not being generated fast enough to finance that, then you have no real alternative but to resort to funny money to pay it off.

And if you look at the experience in the last 16 years, as I say, where we have gone down to about a 30-cent dollar, this prospect, to me, appears not only real but probable. I would like to know how we get ourselves out of this mess.

Mr. VOLCKER. As concerned as I am about the risk before us, I don't share that deepseated pessimism about the impossibility of dealing with it.

It seems to me the answer to your question must be very direct and clear cut: make the earliest and largest attack on that deficit that we can.

Our only instrument, basically, is changing the money supply. You only have two instruments: you reduce spending or you increase taxes. One or the other of those has to be done and it is clear, from the economic standpoint, that the more savings you can make on the spending side, the better.

In trying to put this in some kind of perspective without going out to the year 2000, you have seen and have had before you recently projections by the CBO that are not unreasonable in terms of the interest rate assumption, the budgetary assumptions. If nothing is done—"exploding" may be too strong a word—they show a deficit rising from already high levels, and running out to 1989 and 1990 where they get up to, as I recall it, the $325 billion area. These are not unreasonable assumptions at all with respect to interest rates and assuming current programs, because what you have got is the phenomenon that you allude to of the interest compounding upon itself. Even by 1990, interest becomes a big element in budgetary expenditures.

On the hopeful side, let me say that that kind of cycle can be turned into a more constructive, benign kind of interaction, if you begin working on the deficit. The earlier you work on it and the more you do, the better the prospects. But take those same assumptions that the CBO makes and say we are going to change that expenditure line or change the revenue line to reduce the deficit in the earlier years, and we think it is plausible to believe, as I would think, that that will produce lower interest rates. We now have a lower deficit in the earlier years and lower interest rates, both of which reduce the deficit in the outyears. You then begin finding it easier and easier, rather than harder and harder, to get the budget back in some semblance of balance.

What that kind of arithmetic exercise—which is all it is—shows you is, I think, that however difficult it is to deal with the budget problem now, it becomes increasingly difficult the longer you wait and increasingly easier the quicker you do it.

Mr. Crane. I quite agree with you, Mr. Chairman.

The only remaining question to be answered is when we not only have our budgets in balance but when do we begin honest-to-goodness debt reduction of our national debt? Because so long as that broadening presence of $1.5 trillion or whatever it is when we just hit the $1 trillion mark, as I recall, in 1981—at the rate it is growing, it is beyond human comprehension. And for that reason, I think people have kind of thrown their hands up in despair. They don't understand what this means, the implications of it.

But it seems to me that the implication of it is pretty clear in the context of a warning Abraham Lincoln made that no Napolean commanding the greatest legions of western Europe can force a drink out of the Ohio River, and if this country ever went under, we would be the architects of our own destruction.

I thank you, Mr. Chairman, for your testimony.

Chairman Gibbons. Mr. Chairman, I want to applaud you for your outstanding performance over your long career of public service. You have been coming before this committee now for, as I recall, 14 or 15 years. It seems that long. And you are always intelligent. You are always patient and you are always a good leader, a good teacher.

I hope that all of us can learn from you.

Mr. **Volcker**. If I may simply amend your statement by saying "20 years." I hope that I do not wear out my welcome, Mr. Gibbons. I appreciate it.

Chairman **Gibbons**. You will never wear out your welcome. I am afraid some of us may wear out ours, is the problem.

Mr. **Frenzel**. Will the chairman yield?

Chairman **Gibbons**. Certainly.

Mr. **Frenzel**. There is no need for me to reinforce the chairman's statement because this committee is not a partisan one, but that comes from both sides, of course.

Chairman **Gibbons**. Yes, sir. I want to applaud what you have done to fight what was many times a lonesome battle to contain inflation, to preserve the value and the strength of the American dollar and the economic system.

I know that you must be doing all of this at a great personal sacrifice. If you were out in the private sector, I know your earnings would be vastly greater than they are serving in the position you are in. So I want to applaud you.

And on the parochial side, I want to say that that dollar-and-a-quarter breakfast we bought you this morning certainly did pay handsome dividends. Maybe I can say on an even more parochial side, since my constituents make cigars, that smoking cigars at 7:45 in the morning and eating grits and drinking Florida orange juice certainly gives a person a lot of stamina.

We appreciate you coming and breaking bread with us, eating grits, smoking our cigars and drinking our orange juice, as well as educating us.

Mr. **Volcker**. I greatly appreciate those kind words, Mr. Chairman, and I would be delighted to break bread with you at any time. I should leave the cigar at home. Maybe we can see you down at our breakfast room one day.

Chairman **Gibbons**. Thank you, sir. Thank you very much for coming.

Mr. **Volcker**. Thank you.

Chairman **Gibbons**. Let me make a couple of administrative announcements here.

Because of the shortness of time that we have today, we have had to ask the UAW and the AFL–CIO to appear on Thursday instead of today; that is on April 12, the coming Thursday.

Our next panel of witnesses is from the banking community. First, Mr. Richard S. Peterson, who is the senior vice president of Continental Bank in Chicago, and Mr. H. Robert Heller, vice president of international economics for the Bank of America. We would ask these gentlemen to please come forward.

Gentlemen, we appreciate your waiting so patiently. Mr. Peterson, suppose you lead off; you may proceed as you wish.

Let me say for the record, all statements made today will be included in full at the appropriate place in the record, including Mr. Volcker's, which I forgot to put in the record.

Go right ahead.

STATEMENT OF RICHARD S. PETERSON, SENIOR VICE PRESIDENT AND ECONOMIST, CONTINENTAL ILLINOIS NATIONAL BANK & TRUST CO. OF CHICAGO

Mr. PETERSON. Thank you, Mr. Gibbons. I did not mind waiting at all because I learned a lot this morning as usual.

Chairman GIBBONS. You know we have been in the presence of a great public servant and a great leader. And I want to say he came to breakfast with us this morning at 7:45 and he has been on that witness stand almost 3½ hours, which sets some kind of endurance record for patience as well as intelligence. None of us can usually speak for 3½ hours or even 15 minutes, but he has done that.

We appreciate what he has done.

Mr. PETERSON. The only difficulty following Mr. Volcker is you have to try to find something new to say.

Chairman GIBBONS. Yes, it is a tough act to follow.

Mr. PETERSON. And therefore, I will just make a few brief comments and let my written statement go into the record.

Chairman GIBBONS. All right.

Mr. PETERSON. There is no doubt that we have had, of course, as everybody knows, a very substantial deterioration in our U.S. external accounts and it is raising serious questions not only about the competitiveness of the U.S. industry but also of the problems of the future.

I would just like to say that while we recognize there are a number of things that contributed to this including sharp increases in the dollar, subsidies, and possibly increased consumer acceptance of foreign goods, as well as a number of other factors.

In our view, however, in the recent past the most important factor contributing to the increase in the deficit has been the disparity between the rate of advance in economic activity of the United States and the rest of the world.

Now, this includes two factors. One is our more rapid increase in economic activity than the other industrial countries.

But it also, of course, includes, as Mr. Volcker and others have said, the depressed conditions in Latin America, the problems in the OPEC countries, and generally the increases in imports that we have had from other developing countries, particularly Asia, of nonauto goods.

I think all this relates to the fact that we have had a very substantial improvement in economic activity in the past year fed somewhat by the sharp increase in the deficit and the stimulation that this has had.

While I would argue that most of the deterioration in the trade balance in the past year is due to cyclical factors, the more than 30 percent appreciation of the dollar against the major industrial countries over the past few years has undoubtedly become a major factor also.

I might add, however, in saying this, we find it difficult to find evidence to determine the magnitude of the decline in the deficit caused by the strong dollar in any specific sense. You can use broad generalizations such as provided by the Federal Reserve.

For example, in looking at an analysis done for the International Trade Commission by U.S. Department of Commerce economists, they had a very difficult time determining the extent of the impact of a higher dollar on specific products. There is no doubt that in specific markets and for some specific products, it does reduce the competitiveness of the U.S. producer. But, on the other hand, it is hard to disassociate that from a lot of other factors that have occurred.

In addition, in certain industries, and particularly in the capital goods area, we have had a long-term deterioration in our U.S. international market share. For example, even while the dollar was depreciating substantially in the 1977 to 1980 period, the trade surplus in our capital goods industries, which I might add is our major source of manufactured exports, fell relative to the rising value of our trade imports.

Now, this may reflect again a number of factors including the loss of our technological superiority or, in some cases, merely a shift of U.S. production to overseas facilities. But we have had a long-term decline taking place in this area.

I think the inability to precisely define the causes in the increase of the deficit suggest that finding the right policies to reduce the trade deficit is more difficult to achieve.

I would agree with what Chairman Volcker said today, policy actions that will benefit the longer term economic growth in the United States should also prove beneficial to reducing the trade deficit. Specifically, of course, this means maintaining a slow inflation profile, improving productivity, lowering interest rates and higher investments, and certainly this reflects the fact that we should take steps to reduce the budget deficit.

I would like to just end my statement by saying that we should not be extrapolating the problems in the size of the deficit. We feel that the trade deficit will tend to adjust as the pace of economic activity accelerates overseas and already we are beginning to see an improvement economic activity at a more normal rate of expansion. We feel that this should begin to turn around later this year and we are already seeing it, I might add, in some sectors. Agricultural exports have begun to improve during 1983 and we are seeing some signs of a turnaround in exports of other types of manufactured goods.

I should also emphasize that the widening deficit in the United States, while it is causing problems both here in terms of particular industries and the overall economic policy it is a way of transmitting the U.S. recovery to the rest of the world. Of course, the benefits from trade to the United States should not be underestimated in terms of it, in turn, helping to combat inflationary pressures that could have developed with the type of economic growth we have had.

There is no doubt that actions taken to reduce interest rates would be very beneficial in a number of respects. Certainly it would have a direct and quick impact upon the debt repayment problems of debtor countries. It would also tend to have some impact upon the value of the dollar. While this would take longer to correct the trade deficit problems, it would be beneficial.

In this respect, and just in answer to one question that came up during Mr. Volcker's statement, he is, of course, in a difficult position to talk about that, but as a private economist, I would not want to underestimate the effects of the $150 million reduction in the budget deficit which is meaningful. That is, something new which can be taken by the debt markets as a solid reduction, even if it is somewhat limited in its impact upon the fiscal year 1985 budget deficit, not to say anything about the 1984 budget deficit would have a significant impact.

I think that the debt markets are developing a positive view particularly if we get somewhat slower economic growth which we expect is going to occur, and if we see the inflation being maintained at the 4- to 5-percent rate, which I might add we see. A reduction in the deficit could really have, I think, a more immediate and more significant impact upon the outlook for interest rates than might be inferred by Mr. Volcker's position.

Again, I can say something that he can't say in this respect. But I think it is very important that a budget reduction could be quite beneficial during this year.

Thank you very much.

Chairman GIBBONS. Thank you.

[The prepared statement follows:]

STATEMENT OF RICHARD S. PETERSON, SENIOR VICE PRESIDENT AND ECONOMIST, CONTINENTAL ILLINOIS NATIONAL BANK & TRUST CO. OF CHICAGO

I am Richard S. Peterson, Senior Vice President and Economist with the Continental Illinois National Bank and Trust Company of Chicago. The Continental Bank is the seventh largest commercial bank in the United States with assets of $43 billion, encompassing international activities exceeding $10 billion around the world. Continental Bank is one of the largest banks servicing the needs of corporations in the U.S. and abroad.

The U.S. merchandise trade deficits reached a record $69 billion last year, up from $43 billion in 1982 and $40 billion in 1981. During the fourth quarter, the trade deficit approached a seasonally adjusted annual rate of $90 billion, and based on data for the first two months of 1984 the deficit has continued to grow and is running well over $100 billion. While some modest slowdown in the rate of deterioration may be expected later this year, it is almost certain that the trade deficit will approach $100 billion this year.

The rapid and substantial deterioration in the U.S. external accounts is a rising concern for the growth of the economy. While a part of the deterioration reflected a sharp increase in U.S. imports, the more serious problem was the continued decline in exports for 1983 as a whole. Moreover, the increase in the trade deficit was due largely to a dramatic worsening in the manufactured goods sector, although agricultural exports have also suffered in the past two years.

This raises serious questions about the competitiveness of U.S. industry in both domestic and international markets. Among the responses to this problem has been increased protectionism—already evident in some key industries—and policy actions aimed at reducing the value of the dollar. Before such policies are implemented, however, a more complete understanding of what has caused the deficit is required in order to avoid measures that could cause more harm than good.

I am certain that testimony already presented in these hearings has addressed the problem of determining the causes of the sharp increase in the deficit in recent years. There is little doubt, for example, that the strong increase in the value of the dollar has worked to reduce the relative price competitiveness of American firms. Moreover, some so-called protectionist actions appear to be valid because of the subsidies some foreign governments provide on goods sold into the United States. Other factors such as improved technology by foreign producers and increased consumer acceptance of foreign goods have been contributors. It is our view, however, that the most important factor contributing to the increased trade deficit in the past few years has been the disparity between the rate of advance in economic activity in the U.S. and the rest of the world.

A rise in U.S. economic activity from the end of 1982 to the end of 1983 of 6.2 percent contrasts sharply with the approximately 2 percent average rise in other major industrial countries over the same period. Moreover, most developing countries have shown even more substantial problems. Depressed oil prices have reduced

OPEC export revenues while external debt financing problems have hit the non-oil developing countries and Eastern Europe. Severe austerity programs introduced by all of these countries to conserve scarce foreign exchange have precipitated sharp cutbacks in imports from all industrial countries including the United States.

Nowhere is the impact of developing countries on the U.S. trade balance more apparent than in Latin America where cash-starved countries have been forced to make drastic cuts in U.S. imports. This is in stark contrast to the 1970s when U.S. exports to Latin America grew at a substantially faster pace than in any other major area, reaching a peak of nearly $39 billion in 1981, or 17 percent of total U.S. sales abroad. From 1981 to 1983, however, exports to Latin American fell by 43 percent, reducing the share of total exports to 11 percent. Nearly half of the decline alone was attributable to Mexico, our third largest trading partner. The drop in sales has affected all major categories of U.S. exports, but industries such as farm and construction machinery as well as other heavy capital equipment have been particularly hard hit.

U.S. purchases from Latin America continued to rise, in large part reflecting the pickup in the U.S. econony but also reflecting commodity export support programs initiated to assist these countries. The result was that the U.S. trade balance with Latin America between 1981 and 1983 registered a decline of $21 billion, about two-thirds of the total increase in the trade deficit registered in those two years.

Somewhat the same trend has occurred in other developing countries, although the impact on the trade deficit was somewhat different. For example, export sales to non-Latin American OPEC countries, which also had grown very substantially during the period of rapid oil price increases in the 1970s, declined substantially. However, these cuts were more than offset by the reduced value of U.S. oil imports from these countries so that the net effect on the trade deficit was actually positive.

The U.S. trade position with developing countries in Asia also deteriorated. This primarily reflected increased imports rather than a reduction in exports, and was closely related to the rapid expansion in economic activity in the United States. For example, imports on non-auto consumer goods—including electronics and apparel—expanded rapidly in this period.

Even the trade balance with major industrial countries suggests that the more rapid U.S. economic growth was a major factor leading to higher trade deficits. The balance of trade between the U.S. and Canada deteriorated substantially between 1981 and 1983 when there was virtually no change in the relative value between the U.S. dollar and the Canadian dollar. This is primarily a reflection of the strong pickup in housing activity in the United States. The deterioration in the trade position between the U.S. and Japan deteriorated moderately, although evidence suggests that without restraints—both voluntary and involuntary—the deterioration would have been much more substantial. The trade balance between the U.S. and western Europe which now accounts for less than one-quarter of total U.S. exports was quite large, mainly reflecting the sharp decline in U.S. exports while imports held steady.

While I would argue that most of the deterioration in the trade balance in the past year is due to cyclical factors, the more than 30 percent appreciation of the dollar against major industrial currencies over the past three years undoubtly also has been a major factor. Nonetheless, it is difficult to find evidence to determine the magnitude of the decline in the deficit caused by the strong dollar. Even an analysis by the U.S. Department of Commerce of the impact of the strong dollar on specific products is not clear cut. However, it is possible that since economic activity was depressed in most industrial countries as the dollar gained strength, the full effect of the dollar's appreciation on trade may just be beginning to emerge as the recovery overseas develops at a faster pace, particularly in western Europe.

It still may be noted, however, that in some major products there has been a long-term deterioration in the U.S. international market share. Even while the dollar depreciated between 1977 and 1980, the trade surplus in capital goods deteriorated as exports of capital goods fell relative to the rising value of imports in this period. This may reflect a loss of technological superiority or it may have been due to a shift in U.S. production to overseas facilities. However, even in sectors where the U.S. has held technological superiority, such as aircraft and computer production, foreign competition is increasing and imports are growing faster.

The inability to precisely define the cause of the increase of the deficit suggest that finding the right policies to contend with the trade deficit may be difficult to achieve. What does appear to be important, however, is that policy actions which will benefit the longer-term economic growth in the U.S. also should prove beneficial to reducing the trade deficit. Specifically, this means maintaining a slow inflation profile, improved productivity, lower interest rates, and higher investment. In the longer-run, these objectives will not only benefit the U.S., but lowering interest rates could bring about faster recovery and increased world trade.

Let me summarize my statement by a look at the future impact of a growing trade deficit. First, the trade deficit while large is manageable at only about 2 percent of GNP. Second, the trade deficit will adjust as the pace of economic activity accelerates overseas while the U.S. economy slows to a more normal rate of expansion. This turnaround should begin later this year. Third, a widening trade deficit is the normal mechanism of transmitting the U.S. recovery to the rest of the world, particularly developing countries, and this in turn will boost U.S. export sales. Finally, the widening of the trade deficit has helped to contain inflationary pressure in the U.S. by temporarily satisfying demand until adequate capacity can be constructed. If access to overseas production through imports were not available, it is questionable whether the rapid expansion in economic activity could have occurred without setting off inflationary pressures.

Chairman GIBBONS. And now Mr. Heller.

STATEMENT OF H. ROBERT HELLER, VICE PRESIDENT FOR INTERNATIONAL ECONOMICS, BANK OF AMERICA N.T.&S.A.

Mr. HELLER. Thank you, Mr. Chairman.

As we are all painfully aware, the trade deficit has reached record levels in recent months. This deterioration has serious implications for the value of the U.S. dollar, the position of the United States, and the viability of the U.S. recovery.

Many observers blame the large U.S. trade deficit on the strength of the U.S. recovery and on high interest rates in the United States. While these factors are certainly of some importance, they do not tell the whole story.

But before trying to pinpoint individual causes of the trade deficits, it is appropriate to consider the larger economic interrelationships between the trade imbalance, the governmental deficit, and the connection between domestic saving and investment.

It should also be borne in mind that while the trade imbalance has a physical or real dimension to it, the financial flows provide much of the linkages and feedback effects important to an analysis of the trade deficit.

It is useful to examine the relationship between the Federal deficit and the trade deficit in a flow-of-funds framework. This accounting framework juxtaposes all sources of income in the American economy and the uses of the income earned.

The Government deficit will have to be financed by either a foreign capital inflow or an excess of domestic saving over investment. Thus, the Government deficit can be financed only by a crowding out of domestic investors, an increase in domestic saving, or an increase in net foreign capital inflows—which implies an increase in the trade deficit, or, more appropriately, in the current account imbalance.

Consequently, there is little doubt that a reduction in the Federal deficit would help to reduce the trade deficit. By reducing the Federal financing requirements, more funds would be available for domestic investment and/or a smaller net foreign capital inflow into the United States would be needed.

The key question is how the reduction in the Federal deficit should be achieved: through tax increases or through spending restraint.

Tax increases would further burden the U.S. private sector and reduce its international competitiveness by imposing additional costs on workers and entrepreneurs. This would make it harder for Americans to compete in the international marketplace.

In contrast, spending restraint would have generally beneficial effects.

It has been argued that the trade deficit is mainly due to a surge in imports accompanying the strong U.S. expansion. This is questionable.

Instead, the record trade deficit can be traced to a sharp decline in U.S. exports from their peak of $234 billion in 1981 to $201 billion in 1983. The export declines were concentrated in Latin America, where debt repayment problems and government austerity programs drastically curtailed import spending.

This finding has important implications for trade and economic policy. Clearly, it would be inappropriate to artificially depress U.S. economic activity to hold down imports. Similarly, it would be improper to impose further artificial import barriers to reduce the level of U.S. imports below their natural level.

Instead, economic activity abroad needs to be rejuvenated and barriers to U.S. exports in other countries be reduced. Countries in a balance-of-payments surplus position, such as Japan with its $25 billion current account surplus, are particularly well placed to remove their import barriers. By this they would not only contribute to a better balance in international payments, but also help to perpetuate the global recovery and benefit their own consumers.

It has been argued that U.S. interest rates are abnormally high and that they induce foreign capital inflows into the United States. The argument continues that due to the arithmetic of double-entry bookkeeping, the capital account surplus has to be balanced by a deficit in the current and trade accounts.

First of all, nominal as well as real interest rates have come down sharply from their peaks in 1981, while the trade deficit has mushroomed since then.

Second, foreign capital inflows into the United States peaked in late 1981 and continued to decline in 1983 from their 1982 levels.

Rather than attracting increasing amounts of foreign capital, the United States has been lending and investing less abroad. The U.S. capital outflow has been cut sharply from $118 billion in 1982 to $38 billion in 1983. The United States is not pulling in more foreign capital, but is keeping more funds at home.

Some observers have deplored this tendency and have argued that the United States stands to become a net debtor nation to the rest of the world. This is considered undesirable both on the ground that it will impose additional debt service burdens on the U.S. economy and that it is inappropriate for one of the wealthiest countries in the world to be a net user of foreign capital.

Clearly, both arguments cannot be right at the same time. If foreign debt always constitutes a net burden, poor countries are obviously not better placed to carry this burden than rich countries. It is therefore appropriate to examine these points in some greater detail.

Several observations are in order. First of all, the United States is at the present time the most vigorous major economy in the world. It is therefore natural that Americans invest their resources at home and that foreign funds flow into the United States in order to benefit from and to participate in the economic resurgence under-way here. A cyclical investment boom is now gathering strength.

Second, the deregulation of large sectors of the American economy has provided new opportunities for domestic and foreign investors that did not exist before.

Third, international lending by U.S. banks abroad has been curtailed sharply due to the increasing regulation of international banking activities, the debt service difficulties of many developing countries, and the depressed economic conditions abroad.

All these factors have combined to reduce total foreign lending by U.S. banks from $109 billion in 1982 to $15 billion in 1983. As a consequence, the net foreign investment position of the United States is deteriorating rapidly.

However, one cannot have both a decreased U.S. bank exposure abroad and an increase in U.S. foreign assets in order to bolster the U.S. foreign investment position.

Exchange rates clearly do have an influence on the competitiveness of U.S. industry abroad and the current overvaluation of the dollar on fundamental grounds has made it more difficult for American firms to compete in foreign markets.

In 1979, the inflation-adjusted trade weighted exchange rate of the dollar reached a low of 83.2 compared to the base year of 1973. In that year, the U.S. balance on goods and services registered a surplus of $5 billion. The trade performance continued to improve due to the usual lags involved in the adjustment process.

In 1981, the dollar reached again its 1973 level and after that, the trade performance of the United States began to deteriorate sharply as the dollar became more and more overvalued. As the index of the real exchange value of the dollar reached a high of 117.3 in 1983, the international trade deficit of the United States also reached record highs.

One cannot close a discussion of our trade deficit problems without referring to the very large statistical discrepancy that has not only been characteristic of the U.S. balance-of-payments accounts, but also of the global balance of payments. In 1983, the statistical discrepancy in the U.S. balance of payments was $41 billion, and was by this almost as large as the merchandise trade deficit.

There is some reason to believe that the bulk of the unrecorded transactions is due to an understatement of receipts of service items such as reinvested earnings abroad, investment income, and fees. Consequently, the U.S. current account deficit, if measured properly, is likely to have been substantially smaller than indicated by the officially reported data.

It is important to keep these statistical problems in mind when one designs and implements policies that are intended to rectify an alleged imbalance that may in fact not even exist. Such misguided policy actions may do more damage than good.

Consequently, it is important to proceed with circumspection and caution in this area due to the large uncertainties affecting the data that present the basis of the analysis.

In summary, there exists, first of all, a direct link between the size of the Federal budget deficit and the international balance of payments. The high Federal financing requirements are directly reflected in high and rising trade and current account deficits.

Second, the U.S. trade deficit is not primarily due to a surge in U.S. imports accompanying the U.S. recovery, but due to a fall in U.S. exports. Actions designed to stimulate economic recovery abroad and to remove existing trade barriers to U.S. goods are preferable to further U.S. import restrictions intended to rectify the trade imbalance.

Third, it is not true that high U.S. interest rates have led to a surge of foreign capital inflows into the United States. Instead, the positive balance on capital account is primarily due to a sharp curtailment of U.S. bank lending abroad.

Fourth, while many observers wish to see a further increase in the net U.S. international investment position abroad, it is not possible to achieve this goal when at the same time U.S. lending abroad is being discouraged and curtailed.

Fifth, the current overvaluation of the U.S. dollar has hurt the competitiveness of American exporters. However, little can be gained by a sharp and precipitous drop in the exchange rate. Instead, a gradual and smooth exchange rate adjustment is to be preferred.

Finally, let's keep in mind the statistical problems. Caution is needed, therefore, in the design of policy measures based on reported data.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF H. ROBERT HELLER, VICE PRESIDENT FOR INTERNATIONAL ECONOMICS, BANK OF AMERICA N.T.&S.A.

THE U.S. TRADE DEFICIT: CAUSES AND CURES

The U.S. trade deficit has reached record levels in recent months. In February of this year, the trade deficit exceeded $10 billion. Not only the size of the deficit itself, but also the rate of increase has become a matter of concern to American businessmen and government officials. If sustained, the growing trade deficit has serious implications for the competitiveness of American products, the viability of the recovery, the value of the dollar, and the international investment position of the United States.

Many observers blame the large U.S. trade deficit on the strength of the U.S. recovery and high U.S. interest rates. While these factors are certainly of some importance, they do not tell the whole story. Other influences are probably more important in causing the rising trade deficits. To focus exclusively on the above named factors will lead to an improper diagnosis of the problem and therefore to inappropriate policy prescriptions.

But before trying to pinpoint individual causes of the trade deficits, it is appropriate to consider the larger economic interrelationships between the trade imbalance, the governmental deficit, and the connection between domestic saving and investment. Changing any one of these parameters will have important feedback effects on the other parameters. Therefore, only a broad framework that takes all the interrelationships into account will lead to the appropriate policy prescriptions.

It should also be borne in mind that while the trade imbalance has a physical or real dimension to it, the financial flows provide much of the linkages and feedback effects important to an analysis of the trade deficit. In my remarks I will therefore focus mainly on the financial consequences of the trade imbalance.

1. THE FEDERAL DEFICIT AND THE TRADE DEFICIT

It is useful to examine the relationship between the federal deficit and the trade deficit in a flow-of-funds framework. This accounting framework juxtaposes all sources of income in the American economy and the uses of the income earned.

Americans derive their income from consumption expenditures by others, governmental spending, investment expenditures, and purchases by foreigners, that is, U.S. exports. They spend their income on consumption goods, taxes, saving, and imports. Obviously, expenditures on consumption by one group of people are equal to income earned by others from these consumption expenditures. This leaves the governmental sector, the saving-investment relationship, and the foreign sector to be considered.

The government deficit will have to be financed by either a foreign capital inflow or an excess of domestic saving over investment. Thus, the government deficit can be furnished only by a crowding out of domestic investors, an increase in domestic saving, or an increase in net foreign capital inflows—which implies an increase in the trade deficit or, more appropriately, in the current account imbalance.

Figure 1 shows that the trade deficit has mirrored the development of the federal budget deficit during the last decade. If the trade deficit were eliminated somehow or other, say through a sharp depreciation of the dollar, it follows that foreign capital inflows would also be in balance and that the entire federal deficit would have to be financed from domestic sources. This undoubtedly would drive up domestic interest rates even further, a point to which I would like to return later.

In contrast, there is little doubt that a reduction in the federal deficit would help to reduce the trade deficit. By reducing the federal financing requirements, more funds would be available for domestic investment and/or a smaller net foreign capital inflow into the U.S. would be needed.

The key question is how the reduction in the federal deficit should be achieved: through tax increases or through spending restraint. Tax increases would further burden the U.S. private sector and reduce its international competitiveness by imposing additional costs on workers and enterpreneurs. This would make it harder for Americans to compete in the international marketplace.

The preferred way to reduce the federal deficit is therefore to enact spending cuts or, at the very least, a freezing of current spending levels. These actions will free domestic resources that can be used to create new jobs or to make old jobs more productive and competitive. This greater competitiveness will soon be reflected in more exports and the continuing economic expansion will reduce the need for governmental spending on unemployment and welfare programs. Everyone would be better off.

2. ECONOMIC ACTIVITY AND THE TRADE DEFICIT

It has been argued that the trade deficit is mainly due to a surge in imports accompanying the strong U.S. expansion. This is questionable.

Figure 2 shows that the record merchandise trade deficit of $58 billion in 1983 was not primarily caused by a surge in U.S. imports as the U.S. recovery got under way. In fact, in 1983 U.S. imports of $258 billion were below the peak of $261 billion registered in 1981.

Instead, the record trade deficit can be traced to a sharp decline in U.S. exports from their peak of $234 billion in 1981 to 201 billion in 1983. The export declines were concentrated in Latin America, where debt repayment problems and governmental austerity programs drastically curtailed import spending. U.S. exports to Latin America dropped by some 40 percent between 1981 and 1983. U.S. exports to the other industrialized countries have stagnated since 1980. We may conclude that the depressed level of U.S. exports rather than a surge in U.S. imports is a key factor in explaining the trade deficit.

This finding has important implications for trade and economic policy. Clearly, it would be inappropriate to artificially depress U.S. economic activity to hold down imports. Similarly, it would be improper to impose further artificial import barriers to reduce the level of U.S. imports below their natural level.

Instead, economic activity abroad needs to be rejuvenated and barriers to U.S. exports in other countries be reduced. Countries in a balance of payments surplus position, such as Japan with its $25 billion current account surplus, are particularly well placed to remove their import barriers. By this they would not only contribute to a better balance in international payments, but also help to perpetuate the global recovery and benefit their own consumers.

3. INTEREST RATES AND THE TRADE DEFICIT

It has been argued that U.S. interest rates are abnormally high and that they induce foreign inflows into the United States. The argument continues that due to the arithmetic of double-entry bookkeeping, the capital account suprlus has to be balanced by a deficit in the current and trade accounts.

While theoretically conceivable, this argument is doubly flawed on empirical grounds. First of all, normal as well as real interest rates have come down sharply from their peaks in 1981, while the trade deficit has mushroomed since then.

Second, foreign capital inflows into the U.S. peaked in late 1981 and continued to decline in 1983 from their 1982 levels. For instance, in the first three quarters of 1983, foreign capital inflows into the U.S. were running at an annual rate of $61 billion, which was considerably below their 1982 level of $88 billion.

Rather than attracting increasing amounts of foreign capital, the United States has been lending and investing less abroad. The U.S. capital outflow has been cut sharply from $118 billion in 1982 to $38 billion in 1983 (first three quarters at annual rate). The U.S. is not pulling in more foreign capital, but is keeping more funds at home.

Some observers have deplored this tendency and have argued that the United States stands to become a net debtor nation to the rest of the world. This is considered undesirable both on the ground that it will impose additional debt service burdens on the U.S. economy and that it is inappropriate for one of the wealthiest countries in the world to be a net user of foreign capital. Clearly, both arguments cannot be right at the same time. If foreign debt always constitutes a net burden, poor countries are obviously not better placed to carry this burden than rich countries. It is therefore appropriate to examine these points in some greater detail.

4. INTERNATIONAL INDEBTEDNESS AND THE TRADE DEFICIT

At the end of 1982, the United States had $834 billion in foreign assets and foreigners had invested $666 billion in the United States, for a net investment position of $168 billion in favor of the United States. By the end of 1983, this net investment position had eroded to approximately $125 billion, and it became clear that by the end of 1985 the U.S. net international investment position might erode to zero, if current trends continue.

Several observations are in order. First of all, the United States is at the present time the most vigorous major economy in the world. It is therefore natural that Americans invest their resources at home and that foreign funds flow into the U.S. in order to benefit from and to participate in the economic resurgence under way here. A cyclical investment boom is not gathering strength.

Second, the deregulation of large sectors of the American economy has provided new opportunities for domestic and foreign investors that did not exist before. Consequently, more American capital is staying at home and foreign capital is being invested here for strategic reasons.

The financial sector in particular has benefited from the deregulation process still under way. Foreign banks see new opportunities in the United States, and American financial institutions are eager to broaden the geographic and product diversification of their financial services.

Third, international lending by U.S. banks abroad has been curtailed sharply due to the increasing regulation of international banking activities, the debt service dificulties of many developing countries, and the deprsessed economic conditions abroad.

All these factors have combined to reduce total foreign lending by U.S. banks from $109 billion in 1982 to $15 billion in 1983 (first three quarters at annual rate). As a consequence, the net foreign investment position of the United States is deteriorating rapidly. However, one cannot have both a decreased U.S. bank exposure and an increase in U.S. foreign assets in order to bolster the U.S. foreign investment position. Any action taken to reduce U.S. bank exposures abroad will—pari passu—reduce the U.S. foreign investment position.

5. EXCHANGE RATES AND THE TRADE DEFICIT

Exchange rates clearly do have an influence on the competitiveness of U.S. industry abroad and the current overvaluation of the dollar on fundamental grounds has made it more difficult for American firms to compete in foreign markets.

In 1979, the inflation-adjusted trade weighted exchange rate of the dollar reached a low of 83.2 compared to the base year of 1973. In that year, the U.S. balance on goods and services registered a surplus of $5 billion. The trade performance continued to imporve due to the usual lags involved in the adjustment process.

In 1981, the dollar reached again its 1973 level and after that the trade performance of the U.S. began to deteriorate sharply as the dollar became more and more overvalued. As the index of the real exchange value of the dollar reached a high of 117.3 in 1983, the international trade deficit of the U.S. also reached record highs.

However, one should exercise caution in arguing that a depreciation of the dollar would resolve all of our trade problems. First of all, it would take one and a half to two years before any change in the exchange rate would have a beneficial effect on the trade balance. Due to the familiar J-curve effect, payments for our imports would soar as each dollar would buy less and less foreign goods and the trade balance would deteriorate until the improved export competitiveness would begin to turn the balance.

Second, a depreciation of the dollar would tend to make imported goods more expensive and might well rekindle inflationary forces in the U.S. economy.

Third, as the dollar depreciation would bring the current account into balance, the international capital position of the U.S. would also be balanced. That is, we would no longer be able to finance part of the federal budget deficit from international sources and all the funds would have to be raised domestically. This might crowd out domestic investment more than now and lead not only to higher U.S. interest rates, but might also affect the U.S. recovery adversely.

We may conclude that under current circumstances a substantial dollar depreciation might well turn out to be a mixed blessing. The best that one might hope for is a gradual decline of the real exchange value of the dollar that allows sufficient time adjustment of the trade sector and a concomitant balancing of the federal budget deficit.

6. ACCOUNTING ERRORS AND THE TRADE DEFICIT

One cannot close a discussion of our trade deficit problems without referring to the very large statistical discrepancy that has not only been characteristic of the U.S. balance of payments accounts, but also of the global balance of payments. In 1983, the statistical discrepancy in the U.S. balance of payments was $41 billion, and was by this almost as large as the merchandise trade deficit.

There is some reason to believe that the bulk of the unrecorded transactions is due to an underrecording of receipts of service items such as reinvested earnings abroad, investment income, and fees. Consequently, the U.S. current account deficit, if measured properly, is likely to have been substantially smaller than indicated by the officially reported data. Thus it is entirely possible that the U.S. was in substantial current account surplus in 1983.

It is important to keep these statistical problems in mind when one designs and implements policies that are intended to rectify an alleged imbalance that may in fact not even exist. Such misguided policy actions may do more damage than good. Consequently, it is important to proceed with circumspection and caution in this area due to the large uncertainties affecting the data that present the basis of the analysis.

7. CONCLUSIONS

In summary, there exists first of all a direct link between the size of the federal budget deficit and the international balance of payments. The high federal financing requirements are directly reflected in high and rising trade and current account deficits.

Second, the U.S. trade deficit is not primarily due to a surge in U.S. imports accompanying the U.S. recovery, but due to a fall in U.S. exports. Actions designed to stimulate economic recovery abroad and to remove existing trade barriers to U.S. goods are preferable to further U.S. import restrictions intended to rectify the trade imbalance.

Third, it is not true that high U.S. interest rates have led to a surge of foreign capital inflows into the United States. Instead, the positive balance on capital account is primarily due to a sharp curtailment of U.S. bank lending abroad.

Fourth, while many observers wish to see a further increase in the net U.S. international investment position abroad, it is not possible to achieve this goal when at the same time U.S. lending abroad is being discouraged and curtailed. One cannot have an increase in foreign assets and a decrease in international exposure at the same time.

Fifth, the current overvaluation of the U.S. dollar has hurt the competitiveness of American exporters. However, little can be gained by a sharp and precipitous drop in the exchange rate. Instead, a gradual and smooth exchange rate adjustment is to be preferred.

Sixth, the U.S. balance of payments statistics are subject to very large statistical discrepancies and reporting errors. Caution is therefore needed in the design of policy measures based on the reported data.

FIGURE 1

FEDERAL AND TRADE DEFICITS

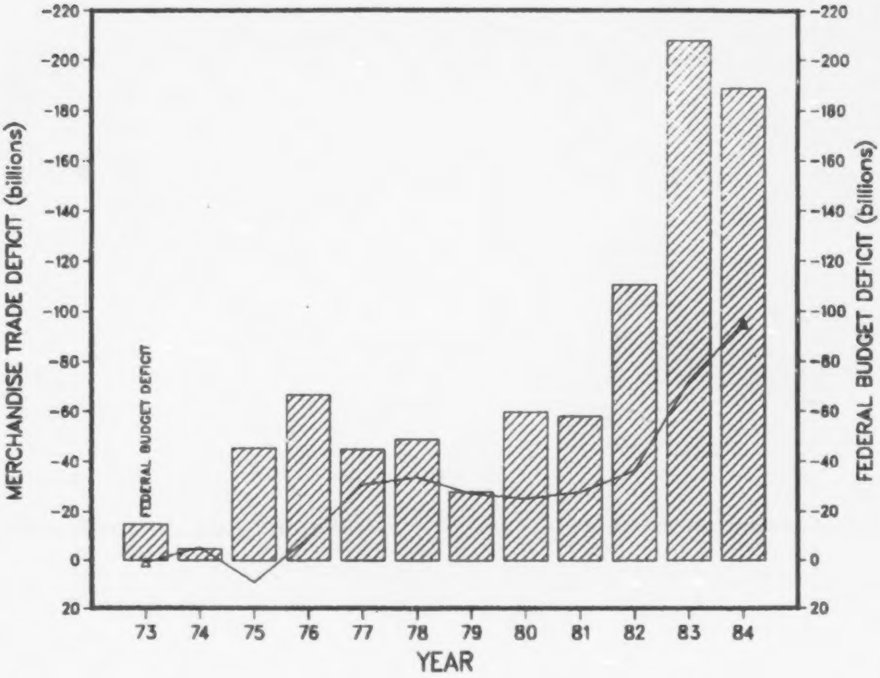
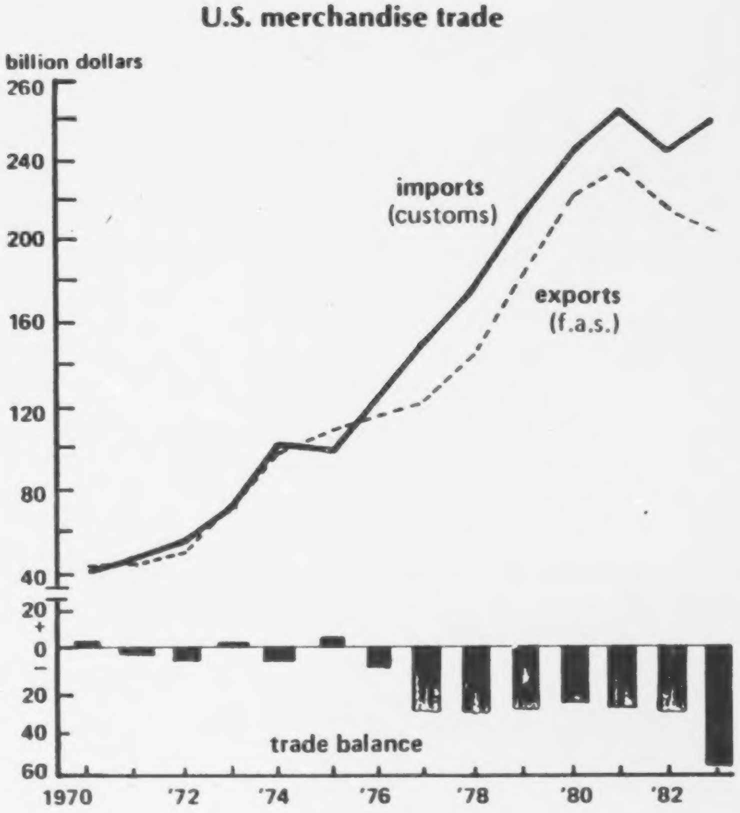


FIGURE 2



Source: Federal Reserve Bank of Chicago

Chairman GIBBONS. I want to thank both of you gentlemen for your very fine and concise handling of the problems in summary.

I have been looking over your statements at the same time. In fact, I want to say, Mr. Heller, that is a shocking figure, the drop-off in lending from $101 billion down to $15 billion.

Mr. HELLER. That is right. Foreign claims by U.S. banks, went down from $109 billion in 1982 to a rate of $15 billion in the first three quarters of 1983. That is an annual rate based on the first three quarters.

Chairman GIBBONS. What do you mean by foreign claims against U.S. banks? Is that a way you describe lending? Those figures again?

Mr. HELLER. 109 in 1982 to about 15 in 1983.

Chairman GIBBONS. That is obviously going to do a lot to our exports, isn't it? Did the exports lead that—the drop-off in exports—or did the drop-off in lending lead the drop-off in exports? What happened?

Mr. HELLER. Clearly, it is a close interrelationship, Mr. Chairman. If U.S. exporters are not exporting, then they do not need the trade financing, and I think it is difficult, to determine whether one is causing the other. I think they go hand in hand.

Bankers are reluctant to engage in additional export financing to countries that already have payment difficulties. On the other side of the ledger, these countries are cutting back their imports from us in the first place. Our exports from the United States to Latin America have dropped some 40 percent from their peak in 1981.

Mr. PETERSON. Could I make a comment on that? It is a very striking number, but I would like to remind Mr. Heller that includes in it is what we call placements in the Eurodollar market. Banks lending to banks, money market activity of some sort, and that very substantially receded in 1983 from 1982. So that maybe overstates the fundamental nature of the cutback in lending that took place by U.S. banks overseas.

There was definitely a cutback in lending to countries associated with their debts, associated with the reduction in world trade and weak economic activity, but that does tend to exaggerate that number a little bit because it includes the money market function.

Chairman GIBBONS. I wish I understood all I know on this subject. It is a very complex subject, I realize.

Let's look at the future. As of about a month and a half ago, Chase Econometrics, DRI, and Wharton were all projecting these figures. This is Chase's figures. This is U.S. merchandize trade deficit in billions of dollars for these years. They say in 1984 it will be $99 billion. It is already running a little higher than that. In 1985 they go up to $100 billion, or about a standstill, and then in 1986 they go up to $104 billion. DRI is showing an even more rapid acceleration; they go from $83 billion in 1984 to about $100 billion in 1985, and to $109 billion in 1986. Wharton keeps it right around $100 billion for all 3 years.

It seems to me that all of those figures on merchandize trade deficits are higher than the ones you generally seem to anticipate. Is that a correct assumption on my part? And, two, what does it mean to us to have figures that are this high over 1984, 1985, and 1986?

Mr. **Heller**. I think it first of all depends on your assumptions about the rate of global recovery in the rest of the world, and maybe we are just a shade more optimistic as far as the economic upswing is concerned in other nations.

Let me also emphasize that it depends on actions taken by other countries.

This morning, Japan was mentioned frequently. Japan is running a $25 billion surplus on the current account right now. They are liberalizing to some extent, but they have a long way to go.

I would say there is quite a bit of scope for more liberalization and with some goodwill on behalf of the countries that are running these surpluses, I think we would be in the position to reduce these deficits. Whether that will actually happen or not, I think that is a question that is largely decided in the political arena, and economists can only guess at what will happen there.

Chairman **Gibbons**. Would you like to comment on that?

Mr. **Peterson**. I would like to say that these numbers are not completely out of line. We might be somewhat lower. I might even say that by 1985 you could be talking of a $90 billion trade deficit, depending on the definition they are using, but still I think your second point in the question is that they are still large numbers.

In other words, we have seen a very sharp acceleration in our trade deficit in the past year, which I would suggest has reflected, at least in part, the sharp increase in imports to rebuild our inventories. We are going to see that slow, and we are going to see a turnaround in our exports to some degree.

Certainly our agricultural exports are improving. So we would say maybe some improvement, but it will be very large.

I might add, however, we would expect a little better trend in the current account deficit, which of course, particularly it includes repatriation of incomes and royalties of U.S. firms who have invested overseas in the past.

As business activity recovers in Europe and in other major industrial countries, many of our U.S. subsidiaries would begin to participate in that kind of recovery directly and would repatriate those funds.

Chairman **Gibbons**. Let me go over your testimony in perspective. Both of you sat through Mr. Volcker's testimony. Do either of you in any way substantially disagree with what he had to say?

Mr. **Heller**. I think Mr. Volcker gave excellent testimony.

Chairman **Gibbons**. What about it, Mr. Peterson?

Mr. **Peterson**. No, nothing in his testimony generally. I might have some comments on some of the questions that were asked.

Chairman **Gibbons**. Mr. Frenzel.

Mr. **Frenzel**. I would like to thank both of the gentlemen for their testimony.

As I understand it, neither of you would dispute previous testimony which says the best way to handle the problem is to get the countries deficit down. Do I misinterpret either of you?

Mr. **Heller**. Very definitely not.

Mr. **Peterson**. No; you do not.

Mr. **Frenzel**. And that is the way you want to go. With respect to the dollar's relationship with other currencies, Mr. Heller, in looking at the final page of your testimony, I take it that you have discovered no manipulation, particularly with respect to the yen.

Mr. HELLER. No, we don't know of any direct manipulation that would have been going on.

Obviously, the same practice that Mr. Volcker mentioned, the restraints that are still in existence in the Japanese financial system, they are more of a structural nature rather than a direct interference on a day-to-day basis. We would like to see these structural barriers removed especially in the international financial markets and capital markets. Also, we would like to see the ability of American and other international banks to participate in the domestic Japanese banking scene enhanced.

Mr. FRENZEL. I take it your caveat on page 8 is that you don't think we should negotiate something that does not have economic reality in it, because that may cause us to get into more trouble. Is that what you are saying there, where you say you don't want any precipitous changes?

Mr. HELLER. Oh, at that moment I was talking about that if the U.S. dollar should drop very, very sharply in the near future, or at some point in time, that in itself will create new dislocations and create new problems, so I would be in favor of a gradual decline in the U.S. dollar.

Mr. FRENZEL. You wouldn't predict any precipitous decline, would you?

Mr. HELLER. Well, it is very, very difficult to predict foreign exchange rates. Anybody who has been in the game for a while finds it an awfully humbling experience.

Mr. FRENZEL. What would be a condition that would cause that? Anticipation of high inflation in the United States?

Mr. HELLER. I think that would definitely be a key factor. If it would be a perception abroad that the U.S. deficits are getting totally out of line, that we are not making progress in solving our problem in that regard; also if there were a return to an easy money policy on behalf of the Federal Reserve, you would immediately see foreign funds being withdrawn from this country, and the dollar as a result would plunge down. We have had that experience in past years, and I think we would see it again.

Mr. FRENZEL. Thank you.

Mr. Peterson, you stated parenthetically that, in commenting on a Volcker statement, that you wanted us to understand that $150 billion was meaningful and was a real cut, and would have some effect in the credit markets.

The chairman's point, as I recall, was that only $25 billion of it is effective in the fiscal year in question, and that fiscal year doesn't occur—doesn't start to occur, until October 1, and so we are talking about a fiscal year that doesn't end for a year and a half, and we are touching a very tiny portion of that $150 billion.

I am delighted to think that you believe that that will have some effect, but it seems to me to be pretty miniscule.

Mr. PETERSON. Let me explain that. First I would say in my comments that certainly more would be better in that sense, but I don't want to get away from the point that you are making. The thing is that there are more things affecting interest rates than of course just size of the budget deficit.

I think we too often say that the budget deficit is the cause of all the problems of the United States. The budget deficit, in its demands on the currency markets, to me, doesn't represent the main problem in higher interest rates.

The perception of the budget deficit by investors is different. It is not the budget deficit today or even sometime further out, which may be fiscal year 1985, but the fact that the deficit does not appear to be under any kind of control, and is exploding. No one appears to be attempting to having it come down at all.

Now this is what bothers the markets. What I am really basically saying is that the outlook for inflation is primarily the fact that it determines the current level of interest rates.

I might add, even the deficit this year, in our view, looking at the numbers, is probably going to be much better than any of us here today expect. We have seen an official deficit estimate of $185 billion. I think it is going to be considerably less than that, and part of this may even go over into fiscal year 1985, because I think that the impact of higher revenues from the expansion is better.

So what we have here, if we could say something about reducing the budget deficits in 1985, 1986, 1987, and of course it gains in impact as you reduce it, I think it would be very beneficial to the markets. It has got to be put in the context of what our outlook is for economic growth, what our outlook is for private credit demands. We do feel that the growth will slow.

The private credit demands will remain relatively moderate, as they have been for some time, so overall growth and credit demands, credit by all sectors, including the Government and the private sector, is only about 10 percent this year. That is not out of line with what we can handle in terms of a noninflationary environment.

Mr. **Frenzel**. That makes you feel a little better.

Would you comment on Mr. Kaufman's speculation?

Mr. **Peterson**. He disagrees with me.

Mr. **Frenzel**. Of yesterday, I guess.

Mr. **Peterson**. Yes. Well, he feels that he would say that the deficit, along with private credit demands, and I guess the strength of the economy, though he didn't quite say that, are going to create total credit demands that are well in excess of what I forecast.

Mr. **Frenzel**. And you would not agree with that?

Mr. **Peterson**. I just wouldn't agree with it, no.

Mr. **Frenzel**. Would you, Mr. Heller?

Mr. **Heller**. I didn't see Mr. Kaufman's statement. I was spending yesterday on an airplane flying out here.

If you look at the Federal deficit of $185 billion and how it was financed last year, I think there are two factors that one should keep in mind.

First of all, the State and local governments were running about a $55 billion surplus during last year. Then you had the foreign net capital inflows of slightly more than $40 billion during last year. Together, that is $95 billion. That means half the Federal deficit was not financed from private domestic credit markets but was financed by State and local governments and from foreign sources.

We simply cannot count on those two sources to continue to finance half the Federal deficit, if it continues to grow, and especially the reluctance of foreigners to put more money into the United States will increase.

Mr. **Frenzel**. Thank you.

Mr. Peterson, you said we are going to do better on the deficit than predicted this year by accident. Do you see that as a function of increased revenues, or the fact that we are simply not capable of spending it as fast as we would like to?

Mr. **Peterson**. Both of them are right. That is what happened last year, too, was our spending was not able to go out as fast as we had projected, as it had been allocated or authorized even, and I think that is a factor working today, particularly in the defense segment. But on the other hand, besides that factor—and that probably will catch up with us in if not this fiscal year, next fiscal year—I think we are definitely seeing—and we will have a better word on this when we get the collective data from the April 15 tax date—I think we are seeing better revenues than expected, and of course the better than expected economic growth is shaving down some of our expenditures that are related to the cycle too.

Mr. **Frenzel**. Do you feel then that CBO and David Stockman and Martin Feldstein have underestimated the growth of the economy in calendar year 1984?

Mr. **Peterson**. Not so much they underestimated the growth of the economy, I don't think. I think it is obviously up from their initial efforts, but we have all done that, so I am not saying that. I think what I would suggest probably is they are underestimating the revenue gaining effects of the given level of economic growth. They may be underestimating the economy too, but I wouldn't throw a stone there.

Mr. **Frenzel**. Do you suspect that more of the difference would be accountable to a deficient revenue model than to their ability to predict overall growth?

Mr. **Peterson**. I won't say deficient because that is a harsh word. Estimating revenue models are difficult. They are very subject to changes in the marginal gain from an increased level of nominal GNP. So I would say yes, they are probably underestimating the revenues that are being generated somewhat from that model.

When we were paying our taxes and withholding our incomes, both corporate and individual, anybody who estimates, you are basing it off of a very, very poor economic year in 1982. We are seeing signs that the final payments are bigger than one expected.

Mr. **Frenzel**. Do you have a personal guess for the deficit for fiscal year 1984?

Mr. **Peterson**. We are talking in our view conservatively around $165 billion.

Mr. **Frenzel**. Which would be what, $20 billion less?

Mr. **Peterson**. $20 billion less than the original forecast by the OMB, $184.7 billion, as I remember the February number. I think they brought that down themselves somewhat.

Mr. **Frenzel**. That would indeed be good news.

Thank you both for your testimony.

Chairman **Gibbons**. Mr. Crane.

Mr. **Crane**. Thank you, Mr. Chairman.

I, too, would like to welcome these two distinguished witnesses before our committee.

Let me address my first question to Mr. Peterson.

In your testimony, you said,

> Our view is that the most important factor contributing to the increased trade deficit in the past few years has been the disparity between the rate of advance and economic activity in the U.S. and in the rest of the world.

I had the privilege of visting Japan under the auspices of the American Productivity Center back in 1981, along with some other colleagues in the House and Senate, business representatives, academicians, and so forth.

One of the questions invariably put to us by Japanese businessmen, in their most polite lights, sooner or later, was, "What are you people doing to yourselves?" Then they went on to point out that here they came out of World War II absolutely devastated, an island with no resources, which has to import all of its raw materials, finish them, and sell a product in world markets in a competitive way, and prosper, and certainly they are perhaps the most shining example of having accomplished an economic miracle, but the point they made to us repeatedly was, everything they are doing they learned here.

They asked the question, for example, why do we punish savings in this country, when they basically exempt interest and dividends from taxation and get 20 to 25 percent of personal income into savings, and we run at the 3.5 to 4 percent level, consider 5 percent a good rate, and we do indeed punish savings and reward debt.

They asked us why we hadn't robotized, when robots were invented in this country, but 70 percent of the operational robots are in Japan right now.

They noted that their labor-management relations, which are a good example many American businesses are now trying to emulate, were pioneered in studies at the University of Iowa in the late 1950's, and they sent teams over here to try to figure out how to increase productivity by having good management-labor relations.

These strike me as so many self-inflicted wounds that, frankly, I don't harbor a great deal of sympathy when, as happened a couple of weeks ago, I had some of the largest steel industry CEO's come visit me asking for a limitation on steel imports in this country for a 5-year period, so that they could modernize about one-third of their industry to make it competitive.

It seems to me, coming out of World War II, when we knew we had a flattened Germany and we had a flattened Japan, it clearly was in our interests to regain the economic health of those two countries as rapidly as possible, and so our assistance in enabling them to build a totally modern steel industry was good for them and good for the free world.

However, it seems to me that American management was remiss at that time in not anticipating what the consequences of that would be, and they did not move aggressively to lay the foundation for a totally modernized steel capability in this country.

Now to hear them come back and sing the blues, frankly, is a little bit hard to digest, and to call for protectionist solutions.

I am happy that that is not the general perceived way by people in the private sector, and Mr. Volcker, as he testified this morning, for us to resolve our problems, but perhaps with humility to go visit Japan, and study how they are making it work so successfully.

Mr. Volcker testified that Mr. Iacocca's charge of currency manipulation on the part of the Japanese was not something that in any way he could document. What would you generally say in response to that same question I put to Mr. Volcker? Do you see any evidence of that?

Mr. PETERSON. None in the statistics. If he said it, he would be the one; he would be able to see it better than we could. I see no reason why he would not be telling us that.

Mr. CRANE. I heard Mr. Iacocca make that charge personally. It is in the current issue of U.S. News & World Report, and it is comforting, I am sure, as a rationalization to many people bucking up against superior quality products coming out of Japan, that are bumping head to head with the domestic products, but it seems to me a little bit like scapegoating, and that there has been a lot of scapegoating on the part of many American businesses.

Let me ask a question with respect to the balance-of-payments figures here. Do those balance-of-payments figures reflect earnings? Are they earnings to American banks from loans made abroad included in our balance-of-payment figures?

Mr. PETERSON. Yes.

Mr. HELLER. That is right.

Mr. CRANE. To what extent then does the failure of a Poland or an Argentina or a number of these other outstanding debtor nations to service their debt—to what extent is that reflected in the 1983 deficit picture there?

In other words, when some of these Third World countries cease honoring their obligations, as Argentina has done, now they have got it papered over, I guess, temporarily, with the backing of the U.S. Treasury; is that correct?

Mr. PETERSON. I am not sure.

Mr. CRANE. Within the U.S. Treasury.

Mr. PETERSON. We are not sure about it.

Mr. CRANE. Guaranteeing the loans from Brazil, Colombia, and Mexico, real creditor nations, right? It is a unique organization to be lending money.

Poland, for example, and Yugoslavia, to the degree those countries that owe billions and billions of dollars to U.S. banks, to the degree they don't honor their loans, what portion of that balance-of-payments deficit do you think reflects on——

Mr. PETERSON. I would defer to Mr. Heller, if he knows any better.

I don't know, do you? I would say it is trivial.

Mr. CRANE. Trivial?

Mr. PETERSON. Yes. In fact, I think Poland settled up in 1983, if there was a deferment in 1982, but don't hold me to that, but it would be relatively small.

Mr. CRANE. Relatively small?

Mr. PETERSON. Potentially much larger, but relatively small so far.

Of course, Argentina was not in 1983, and there has been no deferral. Well, there has been some nonperformance of Latin American loans in 1983, but it is really quite small.

Mr. CRANE. How many of those countries that owe money, that you are aware of, are simply making interest payments without really attempting to retire any of the principal? Have you any idea how many are in that category?

Mr. PETERSON. I don't think there is any country trying to retire principal yet. I don't think any country is in a position to retire principal, like the United States is not in a position to retire principal either. We may roll it over.

Mr. CRANE. That would still constitute a trivial portion.

Mr. PETERSON. Yes; the point is, their debt is going up. I am not sure about balance-of-payments accounting—if they were to repay debt, whether that would show up. I am not sure that would.

Mr. CRANE. I don't know whether it was included.

Mr. PETERSON. I would still say it is a trivial factor. What is more important is what Mr. Heller said. The loan increases, including placements, have not gone up as much. Therefore, the gross interest being received has been less.

Mr. CRANE. I saw in these figures that we are on the verge of becoming a net importer of capital.

Mr. PETERSON. That is a factor there.

Mr. CRANE. Rather than an exporter of capital, and I just wondered how that would be. I saw figures—and correct me if I am wrong—that to finance our debt, about $475 billion of that was coming from abroad last year. Is that the figure?

Mr. PETERSON. How much?

Mr. CRANE. $475 billion.

Mr. HELLER. I think one digit is off. Somewhere in the forties.

Mr. CRANE. Oh, only in the forties?

Mr. HELLER. On net basis.

Mr. CRANE. I was just trying to figure out how much from abroad and subtract from that what they are lending to us.

Mr. PETERSON. You are right that there has been a rapid increase in investment directly or lending to the United States, which has resulted in payments of dividends and interest overseas, and that has been a factor which has reduced what we call our income, our net income—reduced that, and therefore that has contributed to that increase in the deficit. That is important.

Mr. CRANE. Yes. Mr. Heller.

Mr. HELLER. Mr. Crane, I think the $400 billion figure that you are talking about is probably a figure that refers to the total amount of foreign assets that U.S. banks have at the present time. That is just slightly in excess of $400 billion at the end of 1982. There should have been not a very large change in 1983. I would say we have gone up probably to $415 billion or $420 billion.

Now, out of that, we are getting earnings, if you figure an interest rate of 10 to 12 percent, we have an inflow of about $40 billion, but then there is also the interest cost that is involved, because we have to fund these loans, so that it is not a total net inflow into the United States as far as the banking system profit is concerned.

Mr. CRANE. Let me ask you both another question.

When looking at the trade deficits here, under the category "Other LDC's," we have a very unfavorable balance of trade with the LDC's. In fact, it exceeds even the deficit trade relationship we have with Japan cumulatively, and yet it seems to me a part of the dilemma of the LDC's is to bail themselves out to be able to service their obligations, that one of the conditions the IMF attempts to impose is that they export and cut out imports.

Are we in any way working at cross purposes with ourselves? I mean the Congress moved to increase that total lending authority to the IMF as a means of trying to permit those countries to avoid defaults, but on the other hand, they turned around and they say the condition for getting this assistance to service their loans is that you stop importing from the United States, and you massively increase your exports.

I don't see how that kind of policy is consistent with our overall objectives of trying to preserve their solvency, trying to preserve the solvency of U.S. banks that may be overextended in Third World countries, and to that degree, to come back and respond now to a trade imbalance by making any kind of protective gestures, seems to me, is just compounding the problems.

Mr. **Heller**. I fully agree with you.

The IMF obviously is in a very difficult position. On the one hand, for one individual country, yes, you have got to get your financial house in order, and if your debt level has been too high, as shown by your inability to service your current debt properly, then it has to be brought into better relationship to the overall size of the economy.

Clearly, the preferable way of doing that is to grow faster, to have more exports, and therefore it is very important for the United States, for Japan, and other countries that are growing relatively rapidly to open up their markets. I would argue that with our $100 billion trade deficit, we have done more than our share in helping to rejuvenate the economies abroad. It is time for other countries to do the same, at least not to run surpluses, but to help by importing more from these seriously affected countries.

They cannot pull themselves up by their own bootstrap. I shouldn't say they cannot, but at least it would be a very, very painful process. It will be much easier for them if we get economic activity in the industrialized countries going at a more rapid clip, something desirable in its own right, but it would certainly help the developing countries by increasing their exports, and therefore making it possible for them to service their debts.

Mr. **Crane**. Mr. Heller, I was impressed with your testimony that tax increases would further burden the U.S. private sector and reduce its international competitiveness by imposing these additional costs on workers and businesses, and that the preferred solution is to either reduce the deficit or at the very least, put a freeze on spending, to try and gradually bring this thing under control.

I put the question to Mr. Volcker, a theoretical question, which I would like to throw out to both of you gentlemen, and that is in terms of achieving some kind of solution to what, to me, is a horrifying unfolding scenario domestically. The most important thing we can do is to stimulate prodigious, healthy, sustained growth without inflation.

I would ask you the question, as a general principle, which is the better way to promote growth—by keeping taxes low and preserving a maximization of incentives to workers to be productive, because of the chance to make a big buck and keep it, or if you are confronted with the alternative, trying to figure out how to cope with debt, raising interest rates to do that, or trying to keep the interest rates low, and approaching it by rather drastic increases in taxation?

Mr. HELLER. Obviously, the third alternative that Mr. Volcker picked is also the one that I would prefer, holding spending down, but if we restrict ourselves between lower taxes and the lower interest rates—I think in the proposal that you mentioned, your own proposal that you mentioned earlier—trying to bring down interest rates by removing the tax on interest rates, I think that would be a move in that direction and is therefore desirable.

Mr. CRANE. That is what I was kind of leading up to, I wanted to find out if you gentlemen agreed with my legislation that would prevent that double and sometimes triple taxation, as in the case of dividends, because you know, they tax it when the business earns it first, then they make the distribution, and then you get taxed on it a second time, and that is really the third level of taxation, because they tax that money before you ever invested it in that business on the first go-around.

In looking at the Japanese experience, I cannot understand why we have not perceived that we have been hostile to capital formation. We have punished all of those traditional virtues that we seek to inculcate in our kids and everybody else in society, to practice thrift in industry and save your money, and don't blow it on instant gratification, and I cannot help but feel that if we pursue the policy of exempting all that from taxation after the first go-round, that you would see a very dramatic, I mean prodigious decline in interest rates, and a simultaneous building of enormous incentives into our Tax Code for people to save. Do you both share that view?

Mr. PETERSON. I think I come down with Mr. Volcker. Yes, I think the move toward consumption tax carries with it some definite benefits. The only problem is, you know, if I could start all over with a tax system, I think I would start out with more taxes against consumption than against income and investment. I don't know how to get there.

Mr. CRANE. I am not sure that either one is desirable. Why do you want to tax consumption? One of the great strengths of our economy is we have been enormous consumers.

Mr. PETERSON. But that is what you are proposing, isn't it?

Mr. CRANE. No. What I am proposing, frankly, to extend it further, is a debt flat proportional tax of 10 percent on gross income after some threshhold level, because I am not persuaded that taxing consumption, that every time you go out and make a purchase, you are going to be clobbered, is really necessarily a good thing.

Our economic system has thrived on the fact that we have been massive consumers. That has been an ingredient of our economic growth. I am just saying reward savings. Tax in a way that eliminates the discrimination in the code in what is a fair and equitable way that preserves incentives, and I think we could solve a lot of our problems and especially the investments that are being made today based on tax consequences rather than the determination that it is a productive investment.

Gentlemen, I thank you for your testimony. I won't keep you any longer. I appreciate your being here. Thank you very much.

Chairman GIBBONS. Gentlemen, I want to thank both of you for your very fine testimony and for your extreme patience in waiting here so long today. It is very helpful to have your input into solving this problem.

Do either one of you support a surcharge on imports as a solution for our balance-of-payments deficit?

Mr. PETERSON. I would probably say no most times, and I would certainly say no today.

Mr. HELLER. I agree with that. There is no need for a surcharge. Our imports right now are below our 1981 levels, and I think it would further distort the resource allocation between the international sector and the domestic sector.

Chairman GIBBONS. Do either one of you support, or would you recommend, a quota, a mandatory quota, on the importation of steel, such as has been requested of the committee?

Mr. HELLER. Again the answer would be no. I think Mr. Morgan's testimony, who appeared before you a few days ago—is relevant here. Mr. Morgan pointed out that if you impose a steel quota, it will make it more difficult for the U.S. automobile industry to compete internationally.

Each time you are applying one of these Band-Aids, it is not really a Band-Aid. You are just pushing the problem into a different sector of the U.S. economy, and by making steel less accessible, or increasing the cost of steel in the United States, you will be hurting all the downstream industries from that industry further on down.

Mr. PETERSON. I would agree with that point. I just think one thing that brings up, for example, the request on steel is a more complicated factor, which is some of the problem, and one of them of course is the question of subsidization of production of materials, including steel overseas. I think it is a difficult question, and one of the things it raises is technical questions, so we have to work in that direction too, to make sure we are having equitable trade throughout the world.

Chairman GIBBONS. I am going to throw another one out there. Maybe you haven't thought about it, and maybe I shouldn't even ask this question at this time, but I have put forward a proposal that repeals the 30-percent withholding tax on foreign interest obligations.

Mr. PETERSON. Foreign owners.

Chairman GIBBONS. Yes; I don't know whether I am headed in the right direction on that or not. What would be your view?

Mr. HELLER. Again, it is a very complex question, Mr. Chairman. If you would be able to capture truly worldwide distributions, I think there would be some merit in having some foreign taxation on foreigners that is similar to taxation on domestic people.

Chairman GIBBONS. Yes.

Mr. HELLER. Clearly, for a foreigner it is very, very easy to avoid that particular taxation. All he has to do is, instead of putting the money into a U.S. bank physically in this country, all he has to do is put it into a foreign bank account somewhere beyond the reach of the U.S. tax authority. Therefore it is difficult to get any equity by having that kind of taxation in this country.

Yes, I think you can support the repeal of that legislation on the equity ground, because it is difficult to accomplish on a global basis.

Chairman GIBBONS. Mr. Peterson.

Mr. PETERSON. I would tend to agree. It would also make it a little easier for a worldwide market in U.S. Government securities, too, to deal in other markets.

Chairman GIBBONS. Do you feel it would be ameliatory to the problem we now face; is that right?

Mr. PETERSON. I am just not, quite frankly, expert enough on that. I would have to get back to you on that.

Chairman GIBBONS. I want to get your feel of the thing. I apologize for throwing that out.

Mr. PETERSON. I will get back to you.

Chairman GIBBONS. That is not in this hearing. I feel that this withholding is really like a tariff on money.

Mr. HELLER. That is right.

Chairman GIBBONS. It is a tariff barrier to the inflow of capital into this economy. I don't think we ought to be taxing it at a 30 percent rate.

Mr. HELLER. Yes, Mr. Chairman. As I said earlier, there is no way that we are able—that the Congress is able—to impose its will on the rest of the world, because the money just won't be coming into the United States. Instead, it will just be going into a Swiss bank account and earn that same rate of return in a foreign bank account, and the U.S. tax authorities cannot get hold of it.

As a result, it just imposes an inequity on the American banks, because we are sitting in this country, and we have to enforce that particular law, while any foreign bank who does exactly the same deposit taking would not be bound by that particular law, and therefore would be able to attract these deposits. We are penalizing American industry again, and benefiting foreign industry.

Chairman GIBBONS. I want to thank you all again. I apologize for throwing that last one at you, but I thought while I had you here, I might get the benefit of your knowledge.

Mr. PETERSON. Thank you very much.

Chairman GIBBONS. I thank all of you.

This concludes our hearing for today. The next time the committee will meet will be on Thursday morning at 9:30 in the Rayburn Building in room 2247, to continue our hearing with private sector witnesses.

Thank you very much.

[Whereupon, at 12:15 p.m., the subcommittee adjourned, to reconvene at 9:30 a.m., Thursday, April 12, 1984.]

U.S. TRADE DEFICIT

THURSDAY, APRIL 12, 1984

House of Representatives,
Committee on Ways and Means,
Subcommittee on Trade,
Washington, DC.

The subcommittee met at 9:45 a.m., pursuant to notice, in room 2247, Rayburn House Office Building, Hon. Sam M. Gibbons (chairman of the subcommittee) presiding.

Chairman Gibbons. I regret very much having kept you waiting. I apologize for it. I had a speech that I made this morning to a group of employees of the Federal Government and it took me longer than I thought. The questions were very intense and very challenging.

Without further ado, we will take up now on our trade deficit hearings—the National Association of Manufacturers, Mr. Lawrence A. Fox, vice president for international economic affairs; the Motor & Equipment Manufacturers Association, Mr. Ron Hermann, vice president of the association and president of General Automotive Specialty Co., Inc.; the National Foreign Trade Council, Mr. Richard W. Roberts, the president.

Mr. Fox, would you proceed first, please? You may proceed as you wish.

STATEMENT OF LAWRENCE A. FOX, VICE PRESIDENT AND MANAGER, INTERNATIONAL ECONOMIC AFFAIRS, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. Fox. Thank you very much, Mr. Chairman. I appreciate the invitation to appear today.

I am particularly grateful to the committee for the extensive and intensive hearings that you have held on the subject of trade deficit, and I am sure the report of the committee will shed important light on the subject.

Chairman Gibbons. We are going to try. We are going to try.

I tell you I went into this hearing thinking I understood the situation and it is extremely complex. Go right ahead.

Mr. Fox. Mr. Chairman, I have submitted a statement for the record and some statistical material which I would request that you make part of the record.

Chairman Gibbons. All of your statement will be included.

Mr. Fox. Thank you. And in the interest of time, I will summarize my testimony. I know you have a busy schedule this morning.

In 1983, the United States achieved the highest trade deficit in history for the United States or anyone else of approximately $70 million. Of that amount, $39 million, almost $40 million was in manufactured goods.

As you know, the National Association of Manufacturers represents the manufacturing sector of our economy and we represent about 85 percent of manufacturing output in this country.

It is the consensus of our members that the trade deficit is a terribly serious problem. We are deeply skeptical of Polyannish kind of statements which assure us that if we just hang in there, everything will turn out OK in the end. The exchange rate will come down, and our budget deficit will produce a more realistic exchange rate, and the trade deficit will come down. If we persevere, we will come out all right.

We are skeptical of that for two reasons. One, we see no evidence that the exchange rate is going to come down fairly soon. And if it does come down, we have no reason to believe under the floating exchange rate system it is likely to remain down. It is necessary for American manufacturers, if they are to be competitive, to invest in new plant and equipment.

They are suffering, in effect, a double whammy from high interest rates. A new investment in plant and equipment is exceptionally expensive and they don't know whether they can sell their products in the United States or in world markets to the extent that they have to deal with either important competition or competition for third-country markets.

We regard the dual problem of the budget deficit, which, of course, is a principal reason relating to the exchange rate problem, and the trade deficit itself as the two most important economic problems facing the country.

Now, while the United States has begun racking up the worst trade record in history, our good friends in Japan and Germany have been doing a lot better. Both the United States and the other two countries started out in 1970 roughly even. The United States had a trade surplus in manufacturing, and I am talking about manufacturers now, of $3 billion or $4 billion, and Japan and Germany had a trade surplus of $13 or $14 billion.

Last year, while we had a deficit in manufactured goods of about $40 billion, Japan had a surplus, global, in manufactured goods of about $110 billion, and Germany had a surplus of close to $80 billion.

Now, I don't think that that represents in any adequate way the relative competitiveness of the American economy. We are not simply that poor at manufactured production. I think it represents something else.

Now, in my view, and it is the view of our association, the No. 1 problem that it represents is the exchange rate. We share the view with a number of others and the Council of Economic Advisers that about half the problem of the deficit this year is associated with the exchange rate. There are other causes that relate to slow business conditions abroad.

Latin America has run out of foreign exchange. They are usually one of our best customers, and we feel that the factors of oil trade, which provide a certain built-in negative feature in our account, is what the economists call the structural deficit.

Those factors are all important. But the most important single factor is the exchange rate and we think the U.S. Government ought to get at it.

Now, the solution to the exchange rate problem is really not all that difficult. I think there is a consensus in the Congress and in the country that the No. 1 problem is the budget deficit. The budget deficit leads to high interest rates, and high interest rates attract foreign money and the dollar rises.

In the report of the Council of Economic Advisers, the statement is made that it may take as long as 10 years for the dollar to recede to a normal level from the standpoint of trade competitiveness. I don't think we can wait 10 years. Our manufacturing sector of the economy thinks we can't wait 10 years. And I think suggestions that we have that length of time to adjust to the new conditions of world competition are simply wrong.

Now, to deal with the exchange rate problem, you have got to get the budget deficit going down. But that is not enough. I think that is an absolute requisite but it is not enough.

It is the view of our association you have got to do something about the floating exchange rate system itself. Since 1973 when the floating system went into effect, the dollar has been overvalued in real terms.

I am using figures from the Morgan Guarantee Co., which is the best source on this subject. They say that the dollar has been overvalued since 1973 in every year except 1978.

Now, even if American manufacturers were all geniuses, and some of them are, they could not overcome the exchange rate disadvantage that they now face.

According to the Council of Economic Advisers, the current degree to which the dollar is out of line probably is in the range of about a third. There are different ways to measure that, and I am not going to try to repeat the testimony that you have already had, Mr. Chairman, but it is obvious that the misalignment is really serious and it impacts our manufactured goods sector and, I would say parenthetically, our agricultural sector.

Our agricultural prices are out of line in terms of world market prices because the high value of the dollar makes American wheat and soybeans too expensive relative to Brazilian beans and wheat from Australia.

So to get at this subject, you have got to do the budget deficit in a serious way. It does not mean you have to solve that overnight, but it means you have got to demonstrate to the financial markets that we mean business and we are on our way.

Then we think you have got to do something about the floating exchange rate system. There is quite a consensus of views now arising in part from the Williamsburg Summit last year that in addition to the budget deficit, there should be better coordination among the major countries with respect to macroeconomic policy. We agree with that.

There is also, I think, a consensus that this is a time for coordinated currency intervention by the U.S. Government. Now it seems to be only in the case of disorderly markets or crisis. In the case of the other major countries, they see a bigger role for intervention.

I am not going to take sides in that issue. Personally, I think some kind of increased structure in the exchange rate system is needed.

There have been suggestions from famous people in the field like Bob Roosa and Johannes Witteveen, the former Managing Director of the IMF, and Frank Southard, Director of the IMF in America for many years, that a target zone system ought to be considered. There is no guarantee that a target zone system would work, but we ought really to give it some further thought instead of just dismissing it out of hand, say in effect that the market is never wrong and whatever the market says a currency is worth has to be right.

We know that can't be true because now it is evident that the Japanese currency value is not determined by the market entirely. It is determined in part by Japanese domestic and international financial policy. And we know the European currencies, their rates are not entirely determined by the market.

In my opinion, and this opinion is shared by many others, to a degree, the European currencies are all undervalued as a result of the European snake. So we don't really have a free market for currency out there, and I think it is necessary to recognize that in formulating American policy to deal with the exchange rate, which, as I have said, is the most important factor affecting our competitiveness.

But I would go on to say, if we got the exchange rate right—and by that I don't mean exactly right, I mean sort of within the ballpark from a trade standpoint—we still would have an important trade problem.

We have lost competitiveness relative to Germany and Japan and Korea and many other countries for reasons that we all know. There are fundamental changes in competitiveness that are reflected in a number of factors—technology, labor costs. The modern world has moved in a direction to sort of catch up with the United States relative to where we were in the 1950's and 1960's. That is simply a fact of life.

Beyond that, however, there is another factor, and that is government intervention. An awful lot of the catchup effect in other countries is due to foreign government industrial policy and foreign government agricultural policy.

I know, Mr. Chairman, you have given a lot of thought to how to deal with that subject and I think we need an address to that matter of government intervention. There is a distortion of what some people call comparative advantage; in too many cases it is a result of government intervention. We need a solution to that.

Hopefully, that solution should take place in concert with other countries through the GATT but maybe we have to do something to get the attention of the other countries because they are pretty happy. They sort of like this exchange rate. Despite their claims to the contrary, they sort of like it.

Most observers think our $20 billion trade surplus with Europe has been wiped out almost entirely due to the exchange rate and these factors of advantages that accrue to exports through government industrial and agricultural policies are sort of comfortable.

I am not suggesting any trade war kind of stuff, but I think we simply have to recognize that in trade there is not exactly a free market out there either. We would like to perfect it in terms of the direction of free market, and that is sort of the way the GATT is organized. But we are kidding ourselves if we think there really is a free market for trade out there.

Then I would say finally, to wind up, the U.S. Government is making part of this problem worse by its antiexport policies. Aside from the exchange rate, which has been neglected in this administration—although I do say they finally have come to see the Japan situation more realistically—there are other U.S. Government policies that are really hurting us.

The Eximbank has been cut back so much it is puny relative to the export credit agencies of other governments. Eximbank finances participate in financing about 4 percent of our exports and the corresponding figure for Japan is 40 percent. For France it is close to 40 percent, and, you know, we are just not that good that we could overcome the exchange rate and the lack of export credit.

And factors that are also relevant and I think very important is that we punish our exports with taxes. Our DISC is puny relative to the impact of the value-added tax in other systems of that type and it is clear that American manufacturers, having no tax advantages on the export side to speak of, the DISC is valuable and I hope the Congress continues it. But it is puny relative to the value-added tax, and having no sort of government policy to encourage exports other than to talk about it is an obstacle that is just about impossible to overcome under present exchange rate circumstances.

I would say finally in terms of antiexport policies, the U.S. Government has a unique one, really special, and that is our Export Administration Act. We punish our exports to friends as well as foes. I think that matter is before the Congress now. I hope it can be improved in the current consideration in the Congress for the extension of the Export Administration Act.

Thank you.

Chairman GIBBONS. Thank you.

[The prepared statement follows:]

STATEMENT OF LAWRENCE A. FOX, VICE PRESIDENT FOR INTERNATIONAL ECONOMIC AFFAIRS, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. Chairman, Members of the Subcommittee, I am Lawrence A. Fox, Vice President for International Economic Affairs of the National Association of Manufacturers. I appreciate the invitation to appear today to express the views of NAM's members on the critical subject of the causes and remedies of the nation's huge and growing trade deficit. As you know, NAM represents this country's manufacurers and our membership of approximately 13,500 companies produces about 85 percent of the manufactured output of the United States.

Appearing as I do toward the end of a most extensive and thorough examination of the U.S. Trade position I am conscious of the desirability of not repeating at length what others have already said. I will address myself first to the fundamental causes of the trade deficit, and then the basic means by which the trade deficit can be reduced in a rational and constructive way.

I start with the premise that the trade deficit is terribly serious, is undermining the industrial base of the nation, and ultimately if left unattended willl lead to protectionist "solutions" that will have grave consequences for this country and our friends and allies abroad. I do not accept the Pollyanna view that if the U.S. just abstains from protectionism and accepts a little pain a little longer, everything will come out alright in the end with respect to our trade problems—the exchange rate, the number one factor contributing to the present level of the trade deficit, will come down, our most competitive industries will emerge stronger than before and, allowing for a "structural" deficit which has persisted since the mid-1970s, the bulk of our overall trade deficit will melt away.

The problems which have created a $70 billion overall trade deficit in 1983, including an unprecedentedly large $40 billion manufactured goods deficit, are long-term not short-term. This includes notably the misalignment of the U.S. dollar in exchange markets, which has not occurred just since the run-up of the dollar in 1981-83, but as demonstrated in a recent report by Data Resources Inc., has been a persistent feature of most of the post-World War II era, especially since the mid-1960s. The loss of both demestic and overseas markets to foreign ocmpetition has not been due to just a "natural" shift in comparative advantage, but reflects a real long-term loss of U.S. industrial competitiveness across the board, and this loss of competitiveness may dramatically and irreversibly alter the sturcture of our economy. I propose to analyze our present trade deficit in light of such long-term trends, Mr. Chairman, to make it clear that we are presented with more than an unfortunate time coincidence among high domestic growth that increases U.S. imports, low foreign growth that reduces U.S. exports and the exacerbation of the business cycle problem resulting from a temporary over-valuation of the dollar for trade purposes. In this view of our trade situation, the U.S. government must make some difficult domestic and international economic policy choices now, rather than to continue to reassure us that in the long-term our trade balance will improve.

Mr. Chairman, while my focus today is on long-term trends leading to recent high annual trade deficits, the NAM International Economic Affairs Department has just published a detailed analysis of the nature and composition of the record 1983 trade deficit. I would like to submit this report, including the statistical charts and tables for the record.

The U.S. trade deficit: Its scope and its consequences.—The record $70 billion U.S. trade deficit in 1983 and the projected worsening of that deficit in 1984 have caused analysts to look at U.S. foreign trade performance in a new light. No longer of marginal importance, net exports of goods and services may indeed become a major drag on future economic growth. Our own economic recovery of 1983—mainly led by consumer demand rather than capital spending—combined with the high dollar has served to stimulate an inflow of imports. Exports, especially manufactured goods, have fallen for two years, and as yet show no sign of regaining the record levels of early 1981. According to Commerce Department figures, total exports fell by $33 billion in the last two years, leading to a loss of about 1.3 million jobs—almost a fifth of all export-related employment. Our 1983 trade deficit in manufactured goods was $39 billion, by far the worst performance ever. This year, the overall trade deficit is expected to exceed $100 billion. A deficit of this size represents such a magnitude of GNP loss that it seriously threatens future economic growth.

CAUSES OF THE TRADE DEFICIT

At the risk of bringing a smile to your lips, let me say that our trade problem is simply that we are importing a great deal more than we are exporting, i.e. we are buying more than we are selling. We used to be able to say that this is not necessarily all that bad because in so doing we were raising our standard of living—and as a nation we could pay for the imports because we were earning a great deal on our investments abroad and the sale of non-merchandise services. Simply stated, this confortable view has been seriously undermined by the transformation of the United States from the status of a creditor nation to a debtor nation. This transformation will take place in a statistical sense according to Dr. Martin Feldstein some time in 1985. Although the causes are complex, the result is simple: the huge and continuing federal budget deficit is being financed to a great extent by borrowing money from foreigners to whom interest and principal must be paid in dollars.

According to the Council of Economic Advisors 40 percent of the federal budget deficit is directly or indirectly being financed by capital coming from abroad. Therefore, if we cannot pay for our imports with exports and we cannot make up the difference by private sector earning abroad, we obviously are getting into deep trouble. Bear in mind just turning from international creditor to debtor does not immediately start red lights to flash or alarms to ring. But, if unchecked, financing public debt abroad will lead to consequences that ultimately will dim prospects for continued growth in our standard of living. Obviously, the budget deficit must be brought under control to deal with the frightening situation I have just outlined.

EXCHANGE RATE CAUSES OF THE TRADE DEFICIT

The principal cause of the deterioration in the U.S. trade position since 1980 is the exchange rate for the dollar. The size of the federal budget deficit is the most important cause of the over-valued dollar.

Overall, the President's Council of Economic Advisers (CEA) in its Annual Report of 1984 notes a 52 percent increase in the value of the dollar since 1980, as measured against the currencies of 10 major U.S. trading partners. Since January, the dollar has only receded slightly from these high levels. The CEA further calculates that the "real" appreciation of the dollar is 33 percent over the average value for the entire 1973-79 period, i.e. since the introduction of the floating exchange rate system. In other words, the floating exchange rate system that was introduced to help correct the misalignment of the dollar that developed under the Bretton Woods system has simple not worked—indeed, it clearly has worked in reverse so far in the 1980's and contributed to our worsening trade problem. In the published calculations of the highly respected Morgan Guaranty World Financial Markets survey, the "real" (inflation-corrected) exchange value of the dollar has been above the "real" 1973 parity level in every subsequent year except 1978. Unless we get the exchange rate right, and I do not mean exactly right but right in a "ball-park" sense, we had better make plans for continuing trade and balance of payments deficits and ultimately a lower standard of living than could otherwise be achieved.

The Committee has heard a good deal about the exchange rate problem. Rather than provide detailed comments on the development of the problem, I call your attention to the text of a February 22, 1984 speech which I delivered to the Conference Board's annual Financial Outlook Conference entitled, "The Strong Dollar, the U.S. Trade Position and the International Monetary System." Copies are available to the Committee and for inclusion in the record. The speech outlines the history of the exchange rate problem, what it is costing the nation jobs and in the unnecessary decline in our industrial base, and what can be done to overcome the problem. There is a solution to the exchange rate problem if we just get at it.

How to correct the exchange rate problem: Reduce the budget deficit and modify the floating exchange rate system.—I agree with the generally held view that the net effect of the deficit is to increase domestic interest rates, thereby creating an alternative set of evils: high inflation, or high interest rates which overstimulate capital inflows and sustain an overvalued dollar. Not only must the budget deficit be reduced, but also the dollar exchange rate must become one of the focal points of U.S. macroeconomic policy. At present, the exchange rate is the residuum of the effects of fiscal and monetary policies determined in accordance with domestic economic goals. However, I do not believe that macroeconomic policy adjustments alone can resolve the problem of the overvalued dollar, primarily because it has other causes in addition to the budget deficit and high U.S. interest rates. Nor do I believe that a sufficient reduction in the budget deficit can be implemented quickly enough to prevent continued and prolonged dollar overvaluation. Reduction in the budget deficit is essential, but alone is not sufficient, to bring about the desired exchange rate result—and sustain the dollar at a reasonable value. To achieve this goal the operation of the international monetary system must be improved.

To achieve the needed improvement in the operation of the international exchange rate system three elements must be addressed:

Improve international consultation and coordination regarding macro-economic policies.—No one government's policy in a vacuum can resolve the problem, and last year's Williamsburg Economic Summit Declaration establishes and emphasizes the principle of improved consultation and coordination among the major industrial economics. Having said this, it also must be added that a vague commitment to consult and possible coordinate will not mean too much unless it is focused on some specific and well-defined policy areas—and exchange rates are the best place to start.

Reintroduce a greater degree of structure into the floating exchange rate system.—This certainly does not mean returning either to the gold standard or the par value system of Bretton Woods days, nor does this mean marginal cushioning of rapid movements in exchange rates in either direction. Many in the trade and financial community in the U.S. and abroad are as concerned with the volatility of the dollar as they are with its persistent overvaluation. Overshooting has proved to be a persistent and unanticipated characteristic of the floating system. Currencies are not commodities like wheat, soy beans or pork bellies, even though some may view currencies in such a light. The responsibility of a government in the currency exchange area is to see that the relative value of its currency—the supply of which is ultimately controlled by the government—is neither too high nor too low in view of a reasonably well-defined set of policy goals and specific indicators.

A number of proposals have been made, most using some sort of "target zone" approach, under which central banks and finance ministries could coordinate their efforts in seeking to regain some control over dollar exchange rate parities without resorting to excessive levels of currency intervention. Such proposals should be given serious consideration rather than being rejected out of hand on doctrinal grounds as being inimical to market forces. After all, many famous figures in the international monetary field favor such an approach, including Johannes Witteveen, Frank Southard, Robert Roosa, and the members of the international monetary group of the Atlantic Council of the U.S.A. Even the failure of such an approach would probably hurt the U.S. economy much less than the present level of the trade deficit. Ironically, one major benefit of such an approach could be to alleviate growing fears of the consequences of a too rapid and uncontrolled fail in the value of the dollar from present levels.

The yen must rise in value and be more fully internationalized.—No market-oriented international monetary system will work properly if the currency of the world's second-largest trading nation is effectively sheltered from international financial market forces. To its credit the Reagan Administration has identified this problem and reached a set of agreements with the Japanese government, announced last November 10, designed to raise the value of the yen, primarily by internationalizing the yen with respect to its use as a transaction currency and as a preferential asset. Full and expeditious implementation of this yen-dollar agreement, particularly through required changes in Japanese law and Finance Ministry policy, is essential. Changes in domestic financial markets in Japan will be required. We have a long way to go to translate the Reagan-Nakasone agreement in principle to an operational reality.

The four policy steps outlined above to deal with the exchange rate problem are not once-and-for-all actions. The steps are interactive and mutually reinforcing, and will require continuing attention by our government and foreign governments to make the international monetary system work reasonably well. To summarize, the suggested approach is: (a) reduce the U.S. budget deficit and adjust monetary policy accordingly; (b) increase international coordination regarding macroeconomic policies; (c) improve the operation of the floating exchange rate system by introducing a target zone approach or other more structured features; and (d) raise the value of the yen by internationalizing that currency and by other means. Should the floating exchange rate system still prove to be inherently unstable, the experience gained in implementing this program would provide a sound basis for devising more extensive reform of the international monetary system.

These suggested steps are based on a resolution on the exchange rate problem, which was approved unanimous by the NAM Board of Directors on February 10, 1984. Mr. Chairman, I would like to submit this resolution for the record of this hearing.

An exchange rate system that gives reasonable assurance that the exchange value of the dollar will realistically reflect U.S. trade competitiveness is essential to arrest the decline in the U.S. industrial base. Correcting dollar misalignment would itself not provide a miracle cure for the trade problem, nor would it fully resolve the issue of U.S. industrial competitiveness. However, the adoption of a comprehensive exchange rate policy would go a long way toward relieving protectionist demands arising from the growing trade deficit. Also, a successful exchange rate policy could reverse our trade deficit, which is undermining our industrial base and seriously impacting our longer-term growth prospects. Conversely, no industrial policy options currently being discussed, no improvements or changes in U.S. trade law, and certainly no general policy of protectionism can undo the pervasive damage to U.S. trade of an overvalued dollar.

It is evident that high interest rates hurt the long-term competitiveness of American industry in two very crucial ways—the high value of the dollar and the high cost of capital for investment in new plant and equipment. Getting interest rates down is therefore the indispensable step in restoring U.S. industrial competitiveness. A credible exchange rate program is the missing ingredient in U.S. economic policy. Clearing up the overhanging cloud of the exchange rate issue will benefit the world economy as well as our own.

NONEXCHANGE RATE CAUSES OF THE TRADE DEFICIT

It is evident enough that the poor U.S. trade performance so far in the 1980s can be explained by reference to the exchange rate, business cycle developments, the developing country debt problem, and the structural problem arising from the necessity to import oil. Half the anticipated trade deficit in 1984 can be attributed to the exchange rate according to the Council of Economic Advisors. The balane can be divided more or less equally among business cycle, LDC debt, and structural factors. To a considerable extent these factors are inter-active.

The exchange rate makes imports too cheap and exports too expensive. The business cycle factor of rapid recovery at home and slow growth abroad increases U.S. demand for imports and tends to reduce foreign demand. The LDC debt crisis and the consequent lack of foreign exchange reduces the ability of some of our major customers, most notably in Latin America, to pay for goods they would like to buy from us. The business cycle factor and the LDC debt crisis accentuate the emphasis on the U.S. market as the best place to direct exports. The debt service problem of the developing countries is further exacerbated by the high interest rates in the U.S. and the high value of the dollar, i.e., they have to export even more to earn the foreign exchange to pay interest on their debt, which of course, is generally denominated in dollars. Thus the high dollar is contributing to both increased imports from LDC countries but is also reducing our exports to those countries.

There is another way to look at the causes of the poor U.S. trade performance that complements the summary analysis that I have just given. This is a longer-term view and is based on differences in policies between the U.S. and our major competitors that have been operating for the past 20 or 25 years.

In this view, the decline in U.S. trade competitiveness is attributable to the following major factors:

(1) Exchange rate—out of line since the mid 1960s, without effective corrective action by the U.S. government.

(2) Taxes on trade—VAT (value added tax) or similar taxes introduced and expanded on a broad scale in Europe, Japan, Canada and elsewhere since the adoption of the GATT in 1949. Such consumption-based tax systems typically rebate or spare taxes on exported goods.

(3) Export credit non-availability—the decline in the role of the Export-Import Bank while the opposite has taken place in official export credit availability in major foreign competitor countries.

(4) The Export Administration Act—a special American phenomenon of hobbling our exports to friends as well as foes.

(5) Expansion of the role of government abroad through industrial and agricultural policy to create export competitiveness and to limit imports.

I would be happy to elaborate on these points in response to questions.

Determinants of fundamental competitiveness.—There is a third way to look at trade performance that emphasizes both general economic policy and the dynamics of the private sector. Before listing the major determinants at this level, I wish to explain the relationship of the exchange rate to such fundamental determinants.

The exchange rate is not supposed to be a determinant of trade competitiveness, but is supposed to be reflective of trade competitiveness and certain other indices of economic strength or weakness in an economic-political sense. It has been almost 20 years since the dollar exchange rate has been a neutral factor in U.S. trade competitiveness. The wrong exchange rate has done a great deal to facilitate the arrival of both Japan and Germany to their present status of near pre-eminence in trade in manufactured goods. As an exporter of manufactured goods, Germany went ahead of the U.S. in 1969. Japan's performance in the 1970s was even more remarkable. The chart on the last page of my Conference Board speech indicates global trade balances in manufactured goods for the U.S., Japan and Germany, 1970-1983. In essence the chart shows that since 1970 the U.S. manufactures trade balance has gone up and down a bit around a zero point, and then has fallen through the floor since the surge of the dollar in 1981. Japan and Germany, on the other hand, each had a manufactured goods trade surplus around $13 billion in 1970—now Japan is well over $100 billion and Germany is close to $80 billion. The corresponding U.S. manufactured goods net balance in 1983 was a deficit of almost $40 billion.

I have repeated the point that the exchange rate has a great deal to do with trade results. My second point is that national economic policies also can and do have a major impact on trade results. The five policies cited above—exchange rate, taxes on trade, export credit terms, anti-export policies such as the Export Administration Act, and foreign industrial and agricultural policies—are critically important. But there is another set of factors that must also be taken into account. For want of a better term I use the term "determinants of fundamental competitiveness."

The "determinants of fundamental competitiveness" concept is a term that covers much of the ground that classical economists, and many modern-day politicians as well as modern-day economists of all persuasions, refer to as "comparative advantage." The factors I refer to are numerous, but include the traditional comparative advantage factors (land or natural resource endowments, labor, and capital). Classical trade theory, however, does not explicitly recognize technology, know-how, nor management or marketing skills. And trade theory assumes perfect markets and thus takes no account of conditions in the market place of monopsony (one purchaser or group of purchasers), monopoly or oligopoly (one seller or group of sellers), or the role of government as a distorter of markets and trade flows.

The determinants of fundamental competitiveness include such factors as technological development, quality of education of the work force, scale of production and unit costs, level of government receipts relative to taxation and social expenditures, inflation, and cultural patterns. The cost of capital, of course, is crucial patterns. The cost of capital, of course, is crucial and is determined by the personal savings rate to a great extent, as well as the mode of taxation of personal income and savings. The level of technological development is not constant and rises with the level and direction of private and public expenditures for science and research and development. Management and marketing skills, as previously mentioned, are very important. That is one reason for all the books about how the Japanese do it. Competition within the meaning of fair competition laws and concepts, government-approved cartels, and government-owned industries are also major factors affecting trade flows and competitiveness.

We do not know as much about the determinants of fundamental competitiveness as you might think. I am hopeful that the President's Commission on Industrial Competitiveness, under the leadership of Mr. John Young, Chairman of the Hewlett-Packard Company, will shed more light on this subject in its report, which is scheduled to be completed by the end of this year. This commission is doing an impressive job, I believe, most notably in the industrial technology field.

CONCLUSION

The United States "created" the rules for the open trading system of the world in the General Agreement on Tariffs and Trade after World War II. The U.S. more than any other country can lead the way, most probably through inadvertence rather than design, in the destruction of the GATT system. The GATT system is a market-oriented system, but it appears that world trade is moving toward a non-system more and more, subject to government intervention. I fear that we see about us the setting of the stage for the replacement of the system of open markets with a hodgepodge of confrontational national industrial and agricultural policies that exalt contradictory nationalistic policies above trade rules. The U.S. is doubtless the least protectionist of major trading countries—but it is the most influential. It is for this reason that it is especially important that U.S. trade policy meet both U.S. needs and the needs of our friends abroad.

A trade deficit of $100 to $125 billion may be in store for us this year. I hope that we do not attempt to cure the problem with the wrong medicine. The exchange rate is the first place to start. No system of trade—neither "free/fair" trade nor autarky—can meet the legitimate need of U.S. industry and labor under the dollar exchange rate that has prevailed for three years and continues today. A system that so palpably does not meet the needs of the largest trading entity in the world is bound to fail and to be replaced. Undoubtedly that replacement will be a non-system, will embody a great deal of government intervention in the market, and will greatly contribute to increased international tension originating in trade disputes and economic retaliation. A prudent course of policy calls for action to correct the misalignment of the dollar as the surest and most powerful step to help restore U.S. trade competitiveness.

NAM

ADOPTED BY NAM BOARD OF DIRECTORS
FEBRUARY 10, 1984

RESOLUTION ON THE EXCHANGE RATE FOR THE U.S. DOLLAR

Whereas a competitive U.S. industrial base is possible only if the exchange rate for the dollar is realistic relative to the currencies of other major trading countries;

Whereas exchange rate policy must be developed within the context of national economic policy, and macroeconomic policies must be shaped with due regard for direct and indirect impact on exchange rates and trade;

Whereas the substantial rise in the value of the dollar against the yen, the deutsche mark and other major industrial country currencies in recent years has more than offset the reduction in the U.S. inflation rate and efforts to improve industrial productivity, thus making American-produced goods less competitive in both domestic and world markets;

Whereas the reduction in U.S. price and cost competitiveness due to exchange rate changes alone has been calculated as costing more than one million jobs in the domestic U.S. economy and has contributed significantly to the 1983 record U.S. trade deficit of $70 billion;

Whereas the effects of the dollar exchange rate misalignment are most serious respecting the yen and the deutsche mark, the currencies of our principal industrial competitors, and have contributed to their very large manufactured goods trade surpluses, as well as to the huge and growing U.S. trade deficit;

Whereas the deterioration of the U.S. trade and current account balances since 1980 has not led to a counter-balancing reduction in the exchange value of the dollar, but rather the dollar has maintained its value or even strengthened significantly against all major foreign currencies;

THEREFORE BE IT RESOLVED that the National Association of Manufacturers recommends that the U.S. develop fiscal and monetary policies designed to achieve progressive elimination of the federal budget deficit and reduction of high U.S. interest rates, and thereby help the dollar reach and maintain an exchange rate appropriate to the U.S. competitive position, while achieving major domestic macroeconomic goals.

BE IT FURTHER RESOLVED that the National Association of Manufacturers urges the development of an explicit U.S. exchange rate policy supportive of U.S. trade performance. Such an exchange rate policy should include:

- Improved coordination and consultation with other countries regarding the international effects of domestic economic policy, with the purpose of reducing dollar exchange rate misalignment, in accordance with agreements reached at the 1983 Williamsburg economic summit;

- Improvement of the present exchange rate system through the introduction of a greater degree of structure, the purpose being to reduce the present dollar misalignment without excessive levels of government intervention in currency markets;

- Special attention to the international position of the Japanese yen, to encourage its greater use as an international transaction and reserve currency, and thereby to encourage greater international demand for the yen relative to the dollar — thus raising its value. The recent agreement of President Reagan and Prime Minister Nakasone is an important step in the right direction and should be fully implemented as soon as possible.

In addition, the U.S. should take the lead in seeking long-term improvement in the international exchange rate system. Consultations with Germany, Japan, other major industrial countries and the IMF to reform the present system should be undertaken, so that it can better achieve the original objective of facilitating trade and investment by reflecting changes in economic fundamentals which determine competitiveness.

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National Association of Manufacturers

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THE STRONG DOLLAR, THE U.S. TRADE POSITION AND THE INTERNATIONAL MONETARY SYSTEM

BY

Lawrence A. Fox
Vice President for International Economic Affairs
National Association of Manufacturers

1776 F Street, N.W. • Washington, D.C. 20006 • (202) 626-3700

The Strong Dollar, the U.S. Trade Position and the International Monetary System

Two years ago, I spoke before this forum and argued that the U.S. dollar was seriously misaligned against the yen and other currencies with respect to American trade competitiveness. The record $70 billion U.S. trade deficit of 1983 and the projected worsening of that deficit in 1984 have in some measure justified the views I expressed at that time. Our own economic recovery of 1983 -- led by consumer demand rather than capital spending -- combined with the high dollar has served to stimulate an inflow of imports. Exports, especially manufactured goods, have fallen for two years, and show no sign of regaining the record levels of early 1981. Our 1983 trade deficit in manufactured goods was $39 billion, by far the worst performance ever. This year, the overall trade deficit may approach $100 billion. A deficit of this size equals such a magnitude of GNP loss that it seriously threatens the sustainability of the present period of economic growth.

Three factors -- the U.S. domestic recovery, the continued high value of the dollar and poor growth prospects in markets overseas (due in part to the effects of the strong dollar and high U.S. interest rates) -- have in effect made the U.S. the market of choice, if not of last resort.

The U.S. economic recovery, combined with the openness of our market to foreign-made goods priced too low for a wide segment of American manufacturers to compete, has made the U.S. economy again the "single locomotive" trying to pull the world economy back on track to recovery. In effect, we are repeating the experience of the late 1970s--except this time the international exchange value of the dollar has not fallen as it did in 1977-78, despite an even worse U.S. performance in the trade and current accounts. For a number of reasons we are not likely to have the kind of export surge that occurred in 1979-80, and are experiencing instead a pervasive industrial decline.

What I would like to do today is to examine the course and the progression of the dollar misalignment problem, particularly in the period since I last spoke to this group. Next I want to address what the consequences have been not only for U.S. industry but for the U.S. and the world economy in general. Finally, I want to discuss corrective measures which might be taken to resolve this problem.

The Misalignment of the U.S. Dollar

In the view of Secretary of the Treasury Donald Regan, "There is no external measure of what any currency is worth other than what the market is telling us it is worth." This opinion, although understandable, is not reflected in Article IV of the IMF Articles of Agreement, as revised in 1976, which begins: "The essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services and capital among countries, and that sustains sound economic growth ..." The ultimate justification of the system, in other words, is in the results obtained under the system, not the ideological purity of the means by which the system operates. I think most of us would assume that currency values in a viable international exchange rate system must reflect fundamental economic developments, as reflected in trade and current account balances, and relative price inflation.

Two years ago, I suggested that the rising strength of the U.S. dollar ignored the superior performance of Japan and Germany in holding down inflation and increasing productivity. At that time I focused particularly on the yen, which continued to fall in value, to an average low of 260 to the dollar in the last quarter of 1982. Last year the yen strengthened somewhat, though its current price of 233 to the dollar compares to an average of 206 in the first quarter of 1981. Meanwhile, the Deutsche mark, on which the evidence on undervaluation was somewhat less clear two years ago, has fallen through the floor, hitting a ten-year low of 2.84 to the dollar in early January of this year. This represents almost a 50% fall since January 1, 1981, when the price of the DM was 1.96 to the dollar. The rise in the nominal value of the dollar against other major European currencies is even more striking -- 85% against the French franc, 65% against the British pound, and 78% against the lira (Table 2). Overall, the President's Council of Economic Advisers in its recently released Annual Report notes a 52% increase in the value of the dollar since 1980, as measured against the currencies of 10 major U.S. trading partners.

What is even more significant than these levels of nominal appreciation is the real rate of dollar appreciation (i.e. nominal rates adjusted for inflation), and its effect on U.S. trade and industrial competititveness. I would like to quote from the CEA's Annual Report:

> Exchange rate trends sometimes match international differences in inflation rates, but that has not been the case in this episode. Very little of the appreciation of the dollar was offset by a more rapid increase in the foreign price level than in the U.S. price level. In other words the dollar appreciated not only in nominal terms, but in real terms as well. The real appreciation of the dollar between 1980 and December 1983 came to 45%. This means that U.S. firms are now offering their products on world markets at prices that on an average have risen significantly relative to those of their competitors, when compared in a common currency.

While the CEA goes on to say that the 45% figure may be somewhat high, given the exceptionally low nominal value of the dollar toward the end of the 1970s, it calculates that the real appreciation of the dollar in this period is 33% over the average value for the entire 1973-79 period.

The perverse operation of the dollar exchange rate and its impact on U.S. manufacturers is indicated by a comparison of currency values with current account and trade balances, for the U.S., Germany and Japan since 1980 (Table 1 and Figure 1). The U.S. current account, trade balance and manufactured goods balance, have all moved in a strongly negative direction. All three set record deficits in 1983: a trade deficit of almost $70 billion, a manufactures deficit of nearly $40 billion, and a current account deficit over $30 billion. By comparison, there has been strong improvement, in the overall Japanese and German current account and trade balances, as well as in their bilateral balances with the U.S. The overall trade and current accounts balances of Japan and Germany have each improved by at least $20 billion in the past three years. And despite slow growth in many markets outside the U.S. and Canada, Germany's manufactures trade balance produced an estimated $75 billion surplus in 1983, an all-time record, while Japan's surplus of $110 billion was near the record of 1981.

The exchange rate problem is not limited to the yen and the D-mark and includes the relationship of the dollar to a broad range of European currencies (Table 2). The fall in European currencies across the board against the dollar, which accelerated in 1983, has combined with cyclical conditions to wipe out the substantial U.S. trade surplus with Europe. At the height of our last export boom, in 1980, total U.S. exports to the EC more than offset a trade deficit with Japan. Since then, the European recession plus the high dollar have depressed the EC market for U.S. goods, while our own recovery combined with the trade effects of the dollar exchange rate have stimulated U.S. demand for European exports. As a result, the U.S. now runs substantial deficits in total trade with all major European countries. The $18 billion deterioration in the U.S. trade balance with the entire EC since 1980 is twice the increase in our deficit with Japan. This turnaround is linked with cheaper European currencies relative to the dollar. As a result, U.S. exports to the European Community have fallen over the past two years even though there has been a net increase in economic growth in the major European economies.

The Consequences of Dollar Misalignment

The U.S. economy and the world economy have been critically affected by dollar misalignment. Not only has U.S. trade competitiveness been greatly reduced, but U.S. and foreign economies have been negatively affected in a number of serious ways, which tend to reduce growth and investment in other countries even though their goods are now more competitive in the U.S. market.

- The overvalued dollar makes U.S. exports too expensive particularly in a low-growth world economy. Total exports fell $22 billion in 1982 and another $12 billion in 1983. Just as a surge of manufactured exports prevented a serious recession in the United States in 1980, the current export decline deepened the 1981-82 recession and weakens the recovery. Both high-technology and traditional industrial products are affected by this decline.

- Low foreign currency values encourage more U.S. imports. Manufactured imports grew slightly in 1982 despite the recession. In 1983 they expanded by 13.5%, as the U.S. recovery got underway. In an important recent study of the decline of U.S. manufacturing industries, Data Resources Inc. estimated a loss of 2.3% in real GNP and over one million jobs in the U.S. economy since 1980 solely due to a misaligned U.S. dollar.

- An overly strong dollar reduces investment earnings abroad. U.S. direct foreign investment fell in 1982 and earnings dropped by almost one-third. One major high-technology company, for example, estimated in its annual report that if the dollar had not continued to strengthen in 1982, the net earnings from non-U.S. operations would have increased by 20 percent instead of the actual figure of 7 percent. The "currency translation effect" is a continuing phenomenon and reduces the private capital available for U.S. firms to invest in new plant and equipment for use in the United States or purchased in the U.S. for use abroad.

- The present high value of the dollar, combined with high interest rates, is bad for most foreign economies. The strong dollar, combined with high interest rates and the safe-haven effect, draws investment capital from other countries to the United States. In response, foreign countries must raise interest rates to keep investment at home -- and this reduces economic growth rates as well as demand for U.S.-made goods. Furthermore, oil is priced in dollars all over the world and thus has become relatively more expensive for other countries. For the less-developed countries, a strong dollar and high interest rates increase the difficulties of repaying

> their foreign debt. To a large extent the inflow of foreign capital is used to finance the U.S. federal budget deficit, rather than for productive investment abroad to help stimulate and then sustain economic recovery abroad. The CEA estimates that 40% of the U.S. budget deficit is financed by capital inflows.

Most of these consequences have a direct or indirect impact on U.S. trade performance, and thus on the U.S. economy as a whole. U.S. exports fell dramatically in 1982 from the record levels of 1981, while U.S. imports -- from virtually every region of the world except the OPEC countries -- held steady or even rose right through the recent recession. This is in contrast to the previous major recession in 1975, when falling imports contributed to a record manufactures surplus and our last overall trade surplus. When U.S. growth picked up in 1983, overall imports increased at a more rapid rate than general growth, despite a ten percent fall in oil imports. In manufactured capital goods, imports increased over 15%, while consumer goods were up over 13%. In automotive products the value of imports increased by 22.5% despite the voluntary export quota on passenger cars by Japan.

In its 1984 Annual Report, the CEA provides a quantitative assessment of the negative impact of a strong dollar for U.S. trade in the context of the general deterioration of the U..S. trade position. It estimates that the real appreciation of the dollar since 1980 will contribute about $54 billion to the anticipated trade deficit of over $100 billion this year. Furthermore, the CEA notes that the rise of the dollar through 1983, "portends further deterioration of the trade balance in 1985."

The CEA ascribes the rest of the anticipated 1984 trade deficit, in roughly equal shares (each between $15 and $25 billion) to three principal causes -- relative business cycles, the effect on U.S. exports of Latin American debt crises and the "structural deficit" which has existed for the past several years. At least two of these three principal causes of our present deficit, I should point out, are also directly related to the high value of the dollar. The CEA report duly notes in its discussion of Third World debt crisis that the rising value of the dollar is a major contributory factor. But the report fails to note that, on a trade basis, the U.S. dollar was also overvalued for most of the 1970s and that this helped create the "structural" situation in which our exports failed to increase sufficiently to cover rising levels of petroleum and non-petroleum imports. If Germany and Japan, with a much narrower export concentration than the U.S., managed to cover all their imports, including oil, with increased exports, there was no basic reason the U.S. could not have done so, at least to a major degree -- a point which I stressed in my presentation two years ago. There was no "structural" trade deficit before 1970, although we were receiving many warning signals of declining U.S. trade competitiveness.

Do the Consequences of Dollar Misalignment Include a Deindustrialization of the United States?

The President's Council of Economic Advisers has readily conceded that the U.S. dollar is overvalued for trade purposes and this affects a broad range of "import-competing and export industries." However, the CEA concludes that while misalignment of the dollar for trade purposes may continue for as long as ten years, there is little evidence that the U.S. is "deindustrializing" as a result or that any drastic policy changes are needed beyond a serious effort to reduce the federal budget deficit. The CEA's conclusions are based on two major points in its analysis of the present situation.

First, a strong dollar, resulting from large capital inflows and a current account deficit, holds down the inflation rate and spreads growth more evenly across the economy. U.S. import-competing and export industries suffer, but domestic industries such as construction and engineering which benefit from a lower-than-otherwise interest rate level, are the gainers.

Second, even with the dollar problem, the CEA sees no evidence of a general U.S. deindustrialization. In a chapter devoted to a condemnation of some recent proposals for a U.S. "industrial policy," the report notes that the U.S. alone among the five major industrial countries actually increased the number of manufacturing jobs between 1973 and 1980. The U.S. has also increased manufacturing output and employment in each of the last three decades, and its long-term performance compares favorably with the European countries and even super-competitive Japan. The CEA does note a shift in the focus of the U.S. manufacturing effort into high technology fields and a consequent loss of competitiveness in some major sectors with serious economic consequences for certain domestic regions or localities. It also notes that as a share of total employment, manufacturing employment has fallen from 34% to 22% since 1950, that the manufacturing share of capital stock has declined from 28% to 24%, and that the manufacturing share of total output is also slightly down over this period. The employment development is ascribed to improved manufacturing productivity and efficiency. The other cited developments are also attributed to increased opportunities in other sectors as a result of general growth, not to an absolute loss of manufacturing competitiveness.

These interpretations are strongly challenged in the new report on U.S. manufacturing industries just released by Data Resources Inc. DRI concludes that insufficient encouragement of domestic capital investment in industry and insufficient attention to the U.S. competitive position in our international economic policies since World War II have led to a serious erosion in our domestic industrial base. DRI stresses the decline in manufacturing's share of total employment and the relatively poor per capita U.S. performance in manufacturing output growth (CEA's figures, which stress total growth, tend to ignore the fact that the U.S. work force tended to grow faster than in other countries over the postwar era). For the period 1965-82, DRI finds that among the six leading industrial countries, the U.S. and the U.K. rank close together at the bottom in terms of growth in manufacturing production per capita and growth in manufacturing as a share of output. And -- most significantly -- the ranking on these two scales correlates closely with per capita growth in gross domestic product (Table 3). As a result, DRI sees the U.S. moving rapidly toward a services-oriented domestic economy, citing the model of Britain, where thriving growth in the services-oriented London region contrasts with stagnation in the principal industrial areas. But services, this study argues, cannot compare with manufacturing as an overall generator of future national economic growth.

The prime international factor cited by DRI is a dollar that has been persistently overvalued for trade purposes since 1949, with consequent decline in the U.S. industrial performance becoming evident by the mid-1960's. I agree strongly that the overvaluation of the dollar is not just a phenomenon which has reappeared since 1980, but is characteristic of most of the postwar era. Low or undervalued currencies in Japan and Europe were used as policy instruments to stimulate postwar industrial recovery, and in general these currencies have been insufficiently appreciated to reflect a "catch-up" in trade competitiveness. As DRI points out, this has been a prime contributor to the secular decline of the role of manufactured exports in the U.S. balance of payments, and the shift to overseas investment earnings to make up for the decreasing ability of our exports to cover imports. Here, then, is what CEA has cited as the "structural" trade deficit in the current account. It has developed in large part not because of inherent uncompetitiveness in the U.S. economy but because the U.S. officially supported too high a dollar exchange rate for too long. And now that the floating exchange rate system has failed to solve this problem -- and since 1980 has undoubtedly exacerbated it -- we see no decisive steps to improve the situation.

The resultant relatively poor industrial performance is affecting our most competitive products as well as those products where it is well known that the U.S. has serious competitive problems. The CEA report unaccountably downplays capital goods as a key internationally competitive sector, when in fact our only major sectoral surplus is in capital goods -- and this surplus has fallen by $20 billion in just two years, as exports in 1983 were $13 billion off the 1981 peak of $80 billion, while imports have increased rapidly to over $40 billion since the end of the recession.

Another instructive example is provided by import penetration in high-technology product groups, particularly electronics. With respect to import penetration, it is quite clear that foreign producers are targeting the high-growth, high-tech area for their marketing efforts. For most industrial product lines, the

Commerce Department's 1984 Industrial Outlook estimates that import penetration -- measured as a share of domestic consumption -- in 1983 was about the same or a little higher than the pre-recession level of 1981. But in hi-tech oriented and highly competitive electronics fields, increases in foreign inroads into the U.S. market have been significant during this short period, as the table shows.

	Imports as Share of Apparent Domestic Consumption	
	1981	1983
Computer Equipment	7.1%	12.7%
Telephone & Telegraph Equipment	4.1%	9.1%
Office Equipment	20.3	27.2
Semiconductors	34.3	37.4
X-Ray & Electromedical Equip.	16.0	19.4

About the only hi-tech sector in which foreign import penetration significantly declined was in aircraft where statistics are notoriously volatile from year to year. However, in parts and components of aircraft (excluding engines), we lost ground and import penetration did rise by over a quarter, from 18.4% to 23.5%. The business cycle argument can certainly explain a rising level of the absolute value of imports, but such significant increases in market penetration over the past two years are obviously linked to the dollar exchange rate problem.

Is deindustrialization the correct term for the situation that has just been outlined? I prefer the expression "decline in the industrial base" to the word "deindustrialization." However, if current trends were to continue for a decade, then I think deindustrialization would indeed have taken place.

What Can Be Done To Solve The Problem?

Two years ago, it was abundantly clear to many of us that the floating exchange rate system, as it evolved after 1971 had failed to achieve its two essential purposes:

-- To facilitate international trade, by allowing currencies to reflect realistically changes in competitive circumstances, free of "artificial" intervention by governments to depress or prop up currency values; and

-- To provide a reasonably stable medium of exchange for international trade and investment transactions.

There are some who argue, however, that the system has worked well, that it has helped liberate international capital movements and facilitated the international financial adjustments necessary after the "oil shocks" of 1973-4 and 1979.

This is essentially the view presented by the Council of Economic Advisers. Aside from Chairman Martin Feldstein's widely reported strictures on the need to reduce the budget deficit, and presumably to adjust monetary policy accordingly, the CEA believes that any other direct policy action runs more risks than benefits to be achieved in moderating the dollar's high value. The CEA's Annual Report considers and rejects in turn protectionism, exchange market intervention and capital controls as solutions to the problem of the overvalued dollar. They believe that the value of the dollar is actually reflective not only of high interest rates but of two very positive aspects of the U.S. economy -- reduced inflation expectations and confidence in the U.S. as a safe haven for capital. High interest rates can be addressed, the CEA argues, through a reduction in the budget deficit and an easing of the "crowding-out" effect in U.S. financial markets. But for the U.S. manufacturers there is no promise of relief other than a Pollyanna belief that somehow, in the long run or the short run, the dollar misalignment problem will be resolved. I quote the CEA on this point:

> Large real appreciations of a currency tend to be temporary. In the long-run, the real value of the dollar is widely expected to fall back to a level that allows U.S. firms to compete in world markets on an equal basis. To believe otherwise would be to believe that U.S. producers can continue to be priced out of world markets,

> and the United States can continue to run 12-digit trade deficits, indefinitely. It is impossible to say when the dollar will come back down. The decline could start in 1984 or it could come later. To judge by past experience,even if there were no unforeseen developments, it could be as long as 10 years before the dollar returns to its long-run value.

Change in U.S. international monetary policy, particularly in regard to exchange markets, is unlikely until there is a basic agreement in the American government as to the causes of dollar misalignment. The safe-haven effect is clear enough, although its weight relative to high interest rates is difficult to determine. At this point agreement ends. Treasury Secretary Regan's dispute with Dr. Feldstein on the significance of the budget deficit is, of course, well known. The Federal Reserve's position on the budget deficit is quite clear, but less so regarding exchange markets. The Treasury views exchange markets as little different from other markets and vigorously opposes currency intervention except in the case of undoubted and severe disorderly markets, and tends to denigrate the importance of the exchange rate issue. In a recent speech here in New York, Deputy Treasury Secretary R. T. McNamar, responding to predictions that the high dollar could cause this year's trade deficit to equal two percent of GNP, said, "Do you want to turn the whole town upside down for two percent of the economy?"

I say that our economy is in the process of being turned upside down, and I think such evidence as the DRI study and even the raw trade data support my belief. Furthermore, I believe that we can at least begin to cope with this problem through a series of steps that are not so drastic as protectionism, a dirigiste industrial policy or a return to capital controls. Indeed, failing to address the exchange rate problem with more moderate approaches now could lead to these more drastic steps farther down the road. And all of the measures I would propose have already been widely considered, or in some ways actually undertaken.

Reduce The Budget Deficit

I agree with the view expressed by Dr. Feldstein and most other commentators, that the net effect of the deficit is to increase domestic interest rates, thereby creating an alternative set of evils: high inflation, or high interset rates which overstimulate capital inflows and sustain an overvalued dollar. Not only should the budget deficit be reduced, but also the dollar exchange rate must become one of the focal points of U.S. macroeconomic policy. At present, the exchange rate is the residuum of the effects of fiscal and monetary policies determined in accordance with domestic economic goals. However, I do not feel that macroeconomic policy adjustments alone can resolve the problem of the overvalued dollar, primarily because it has other causes in addition to the budget deficit and high U.S. interest rates. Nor do I feel that a sufficient reduction in the budget deficit can be implemented quickly enough to prevent continued and prolonged dollar overvaluation. Reduction in the budget deficit is essential, but alone is not sufficient, to bring about the desired exchange rate result.

Improve International Consultation and Coordination Regarding Macro-economic Policies

No one government's policy in a vacuum can resolve the problem, and last year's Williamsburg Economic Summit Declaration establishes and emphasizes the principle of improved consultation and coordination among the major industrial economies. Having said this, it also must be added that a vague commitment to consult and possibly coordinate will not mean too much unless it is focused on some specific and well-defined policy areas -- and exchange rates are the best place to start.

Re-introduce A Greater Degree of Structure Into The International Monetary System

This does not mean returning to the par value system of Bretton Woods days, nor does this mean marginal cushioning of rapid movements in exchange rates in either direction. Many in the trade and financial community in the U.S. and abroad are as concerned with the volatility of the dollar as they are with its persistent overvaluation. Currencies are not commodities like wheat, soy beans or pork bellies, even though some may view currencies in such a light. The responsibility of a government in the currency exchange is to see that the relative value of its currency -- the supply of which is ultimately controlled by the government -- is neither too high nor too low in view of a reasonably well-defined set of policy goals and specific indicators.

A number of proposals have been made, most using some sort of "target zone" approach, under which central banks and finance ministries could coordinate their efforts in seeking to regain some control over dollar exchange rate parities without resorting to excessive levels of currency intervention. Such proposals should at least be given serious consideration and tried experimentally, rather than being rejected out of hand. Even the failure of such an approach would probably hurt the U.S. economy much less than the present level of the trade deficit. Ironically, one major benefit of such an approach could be to alleviate growing fears of the consequences of a too rapid and uncontrolled fall in the value of the dollar from present levels.

The Yen Must Rise in Value and Be More Fully Internationalized.

No market-oriented international monetary system will work properly if the currency of the world's second-largest trading nation is effectively sheltered from international financial market forces. To its credit the Reagan Administration has identified this problem and reached a set of agreements with the Japanese government, announced last November 10, designed to raise the value of the yen, primarily by internationalizing the yen with respect to its use as a transaction currency and as a preferential asset. Full and expeditious implementation of this yen-dollar agreement, particularly through required changes in Japanese law and Finance Ministry policy, is essential. Changes in domestic financial markets in Japan will be required.

I believe that the four policy approaches that I have just outlined, even if they were fully achievable in a short or medium time frame, would not provide a miracle cure for the trade problem caused by a misaligned dollar, nor would they fully resolve the issue of U.S. industrial competitiveness. I do believe, however, that the effects of such a comprehensive exchange rate policy would go a long way to relieving the protectionist demands in this country that are sure to increase with the growing trade deficit that is undermining our industrial base and seriously impacting our growth rate. Conversely, no industrial policy options that I have seen discussed, no improvements or changes in U.S. trade law, and certainly no general policy of protectionism can undo the pervasive damage to U.S. trade of an overvalued dollar. Restoration to health of the industrial sector of our economy is dependent on a realistic exchange rate for the dollar. This will benefit the world economy as well as our own. Is there a better time to get going on this problem than now?

****

The resolution of the NAM Board of Directors, adopted on February 10, 1984 sums up industry's views on the exchange rate issue, and is attached for easy reference.

NAM

ADOPTED BY NAM BOARD OF DIRECTORS
FEBRUARY 10, 1984

RESOLUTION ON THE EXCHANGE RATE FOR THE U.S. DOLLAR

Whereas a competitive U.S. industrial base is possible only if the exchange rate for the dollar is realistic relative to the currencies of other major trading countries;

Whereas exchange rate policy must be developed within the context of national economic policy, and macroeconomic policies must be shaped with due regard for direct and indirect impact on exchange rates and trade;

Whereas the substantial rise in the value of the dollar against the yen, the deutsche mark and other major industrial country currencies in recent years has more than offset the reduction in the U.S. inflation rate and efforts to improve industrial productivity, thus making American-produced goods less competitive in both domestic and world markets;

Whereas the reduction in U.S. price and cost competitiveness due to exchange rate changes alone has been calculated as costing more than one million jobs in the domestic U.S. economy and has contributed significantly to the 1983 record U.S. trade deficit of $70 billion;

Whereas the effects of the dollar exchange rate misalignment are most serious respecting the yen and the deutsche mark, the currencies of our principal industrial competitors, and have contributed to their very large manufactured goods trade surpluses, as well as to the huge and growing U.S. trade deficit;

Whereas the deterioration of the U.S. trade and current account balances since 1980 has not led to a counter-balancing reduction in the exchange value of the dollar, but rather the dollar has maintained its value or even strengthened significantly against all major foreign currencies;

THEREFORE BE IT RESOLVED that the National Association of Manufacturers recommends that the U.S. develop fiscal and monetary policies designed to achieve progressive elimination of the federal budget deficit and reduction of high U.S. interest rates, and thereby help the dollar reach and maintain an exchange rate appropriate to the U.S. competitive position, while achieving major domestic macroeconomic goals.

BE IT FURTHER RESOLVED that the National Association of Manufacturers urges the development of an explicit U.S. exchange rate policy supportive of U.S. trade performance. Such an exchange rate policy should include:

- Improved coordination and consultation with other countries regarding the international effects of domestic economic policy, with the purpose of reducing dollar exchange rate misalignment, in accordance with agreements reached at the 1983 Williamsburg economic summit;

- Improvement of the present exchange rate system through the introduction of a greater degree of structure, the purpose being to reduce the present dollar misalignment without excessive levels of government intervention in currency markets;

- Special attention to the international position of the Japanese yen, to encourage its greater use as an international transaction and reserve currency, and thereby to encourage greater international demand for the yen relative to the dollar -- thus raising its value. The recent agreement of President Reagan and Prime Minister Nakasone is an important step in the right direction and should be fully implemented as soon as possible.

In addition, the U.S. should take the lead in seeking long-term improvement in the international exchange rate system. Consultations with Germany, Japan, other major industrial countries and the IMF to reform the present system should be undertaken, so that it can better achieve the original objective of facilitating trade and investment by reflecting changes in economic fundamentals which determine competitiveness.

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TABLE 1:

Exchange Rates and Trade Balances:
U.S., Japan and Germany 1980-1983

YEAR	USA			JAPAN					GERMANY				
	TRADE BALANCES			TRADE BALANCES			CURRENCY		TRADE BALANCES			CURRENCY	
	Curr.	Trd.	Mfs.	Curr.	Trd.	Mfs.	per $ US**	Chg.	Curr.	Trd.	Mfs.	per $ US**	Chg.
	$	$	$	$	$	$			$		$		
1980	0 Bil	-36 Bil	13 Bil	-11 Bil	-11 Bil	94 Bil	227	--	-16 Bil	5 Bil	63 Bil	1.82	--
1981	5	-40	5	5	9	116	221	+ 3%	- 7	12	62	2.26	-24%
1982	-11	-43	-11	7	7	104	249	-13	3	21	68	2.43	- 8
1983	-34*	-69	-39	20*	32	110*	238	+ 4	4*	20*	75*	2.55	- 5
(Chg. from 1980)								(- 5)					(-40)

* Partial Year Projections

** Average Annual Value, IMF Financial Statistics

TABLE 3:

Per Capita Growth and Manufacturing Production in Major Industrial Countries, 1965-1982

	Real GDP Per Capita	Manufacturing Production Per Capita	Manufacturing Production to Total GDP
Japan	5.2	7.5	2.2
France	3.3	3.3	0.0
Italy	2.9	4.0	1.1
Germany	2.5	2.2	-0.2
United States	1.7	1.0	-0.7
United Kingdom	1.7	0.0	-1.7

Source: Data Resources Inc., DRI Report on U.S. Manufacturing Industries, (1984)

TRADE & INDUSTRY

NAM

March 30, 1984 *Special Issue* Volume II, Number 6

The Trade Deficit and Declining U.S. Competitiveness

by Stephen Cooney

The record levels of U.S. trade and balance of payments deficits in 1983 indicate a pervasive and deepening crisis in the international competitiveness of U.S. manufacturing industry. Since 1981, the U.S. trade balance in manufactured goods has worsened by $44 billion to a deficit of $39 billion. By comparison, Japan had a near-record surplus in manufactures in 1983 estimated at $110 billion. Germany did have a record surplus in manufactures, estimated at $75 billion (figure 1). *The American "export boom" of 1979-81 now appears to have been the short-term result of rapid dollar depreciation in 1977-78. Over the longer run, U.S. manufactured products have lost ground to foreign competition in both the domestic and world markets.*

The overall trade deficit is now so large that, along with the federal budget deficit, it threatens the long-term sustainability of the present period of growth. The Commerce Department has estimated that more than 1 million export-related jobs—well over one-fifth of the 1981 total of such jobs—have been lost in just two years. And the inability of U.S. manufacturers to compete with foreign imports, whose relative production costs are kept low by the strengthening of the dollar, may have had a similar impact on the economy. For 1984, it is widely predicted that the total U.S. trade deficit could top $100 billion, which will increase demands for protectionist legislation.

Data Resources Inc., in a recent report on the decline of U.S. manufacturing industry, states that per-capita growth in U.S. manufacturing production since 1965 is nearly the lowest among major industrial countries, and that the U.S. consequently ranks with Britain as having the lowest per capita growth rate during this period. This poor performance is ascribed in large part to a poor record of international competitiveness in a wide range of industries. The major international cause of the problem, according to DRI, is a persistent overvaluation of the U.S. dollar for most of the last 30 years. As this report shows, and as a recent resolution of the NAM Board of Directors reflects, the rapid appreciation of the dollar since 1980 is a major influence on the decline in the U.S. trade position over the past two years.

The following report provides a detailed analysis of the 1983 trade figures, highlighting developments in specific product groups and in trade with specific geographical partners, as well as overall developments. The charts and tables provide a reference to developments over a longer period. While the rapid U.S. economic recovery has had a strong influence on the rapid increase in the trade deficit, a key conclusion of this report is that misalignment of the dollar for trade purposes has had an even more far-reaching and long-term impact.

Record Deficit in 1983—More in 1984

The United States manufactures and overall trade deficits for 1983 were the worst in history. The manufactured goods deficit ballooned to $39 billion, from a deficit of $11 billion in 1982 (imports measured c.i.f.), and compared to a surplus of $5 billion in 1981. This worsening of the manufactures deficit was the main reason that the overall trade deficit increased by over 50% to a record total deficit of $69 billion. As the high value of the dollar and economic problems abroad continue to retard a recovery of U.S. exports, and as U.S. domestic growth continues into 1984, the Commerce Department now forecasts an overall trade deficit of more than $100 billion this year.

As noted in the 1984 *Economic Report* of the Council of Economic Advisers, the causes of this immense trade imbalance are not difficult to identify. The rapid pace of economic recovery in 1983 stimulated demand for imports, as usual. However, half of the current level of the trade deficit is caused by the high value of the dollar, the CEA estimates.

Rapid growth in the U.S. stimulates non-oil imports while exports struggle. Real GNP growth for the year 1983 was 3.3%, and 6.1% from fourth quarter 1982 to fourth quarter 1983. Import demand gained momentum as economic growth quickened. For the year, imports (measured c.i.f.) grew by 5.9% to $269.9 billion, but fourth quarter total imports ran over 19% higher than the same period in 1982. The overall growth in imports occurred despite further savings on imported oil. Total petroleum imports fell by 12% in 1983 or over $7 billion from 1982. But, the fall in oil imports was reversed in the last quarter, and this trend is expected to contribute to an even larger 1984 trade deficit.

By contrast, U.S. exports fell again in 1983, though not as far as in 1982. Total exports were just over $200 billion, or $12 billion less than in 1982 and $33 billion less than in 1981. U.S. exports fell despite improved economic performance in some major markets—3% growth in Canada following a severe recession in 1982, roughly a net 1% GNP increase in the four major European economies, and higher growth levels in Japan and East Asia. This fall affected agricultural products as well as manufactured exports. Although U.S. exports held steady in the last quarter—indicating a possible bottoming out of the decline—the improvement pales compared to the rapid rise in imports. Overall, the Commerce Department does not project a major recovery in U.S. exports in 1984.

Misaligned exchange rates are the key.

continued

National Association of Manufacturers • 1776 F Street, NW • Washington, DC 20006 • (202) 626-3700

According to the CEA's *Economic Report*, by December 1983 the U.S. dollar was 33% higher on world exchange markets than its average value in 1973-79. As the late Otto Eckstein of Data Resources Inc. stated in the recent report on the decline of U.S. manufacturing industry:

> No degree of cleverness on the part of management, no newfound cooperation between employers and workers, no industrial policies by the federal government can overcome the handicaps of an overvalued dollar and a domestic economy disrupted by credit crunches and recession every three or four years.

The same DRI study estimates that as of July 1983 the appreciation of the dollar since 1980 had eliminated well over 1 million trade-related jobs and reduced the gross national product by 2.3%. While the U.S. has had some success in controlling inflation and halting the decline in productivity, relative success in these areas is overwhelmed by the competitive impact of the dollar's rise. This is what is meant by a dollar which is "misaligned" for trade purposes.

When the dollar appreciated in exchange markets in 1981-82 despite worsening U.S. trade performance, non-oil imports—especially manufactured imports—continued to grow despite the domestic recession. A net 1% growth of manufactured imports in 1982 compared to a fall of over 7% in manufactured imports during the comparable recessionary year of 1975. The difference was due to the effect of an exceptionally strong dollar on imports. It is not surprising, therefore, that manufactured imports took off with the recovery of 1983 as the dollar remained strong, while dollar-priced U.S. manufactured exports fell further in a world market that was recovering more slowly (*see table 1*).

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A Closer Look at Manufactures

Total U.S. manufactured imports increased by 9% in the first three quarters of 1983, then spurted an additional 16% in the last quarter—for a total annual growth rate of 13.5%. By contrast, U.S. manufactured exports fell by more than $7 billion (5.2%) in 1983. As in most recent years, the direction of total U.S. trade performance was determined by performance in manufactured goods. As manufactured exports fell by over $7 billion, imports (measured at customs value) increased by almost $20 billion, accounting for a net negative impact of $27 billion on the trade balance. This roughly equals the overall worsening of the trade balance. The improvement in the oil account only partly offset the loss in manufactures. The agricultural balance also worsened, but only by about $2.4 billion to a net $20 billion surplus. *(See tables 2 and 3 and figure 2 for a detailed analysis of exports and imports by major sectoral and product groups).*

The worst U.S. trade performance occurred in electronics product categories considered critical for future competitiveness. Unlike most products, for example, the United States managed to increase its exports in computers and office machines by 15% in 1983—but imports increased by an astonishing 58%. The net surplus in this field thus dropped by $1 billion, from $5.9 billion to $4.9 billion. Other electronics categories show a similar result. In the large electronic machinery, parts and components category (which includes semiconductors), imports rose by 21.4% in 1983 compared to a 5.3% increase in exports. Exports of telecommunications equipment fell 2.6% in 1983, but imports of nonconsumer telecommunications products rose by over 22% and imports of products such as televisions, radios and video recorders rose by over 29%. Over the past year, the United States has become a net importer of electronic machinery parts and components, while the total deficit in consumer and nonconsumer telecommunications equipment has worsened by about $1.5 billion.

Total U.S. capital goods exports fell by over $5 billion or 7.6% in 1983, while imports rose by a similar dollar amount or 15.5%. Capital goods is traditionally the strongest U.S. trade sector, with the largest surplus. Since 1981, the U.S. capital goods surplus has fallen from $46 billion to $26 billion.

Outside of electronic product areas already discussed, capital goods import growth was highest in agricultural machinery and tractors (20%) and power-generating machinery, including engines (17.8%). In both of these areas, U.S. exports fell substantially. Professional, scientific and controlling equipment imports showed a more moderate increase (11.8%) in 1983, while exports only fell slightly (1.7%). Import growth was much lower or negative in construction and special-purpose machinery, in general industrial machinery and parts and in metalworking machines and machine tools (imports actually down over 20% in the last category). But in these product areas, exports also performed much worse: exports of construction and special-purpose machines fell by 29%, machine tools fell by 31% and general industrial machinery and parts fell by 19%.The only really bright spot in the capital goods area was in the often volatile field of aircraft and parts, where total imports fell about 20%, exports produced a 3.4% gain, and the net U.S. surplus improved by $700 million.

The overall deficit in automotive products worsened by $6.4 billion in 1983 and, at $24 billion, was double the 1981 deficit. Despite the import quota on the number of units from Japan, the cost of new passenger car imports increased by 16% to $22.9 billion in 1983, contributing to a total 22.5% increase in imports in the automotive products sector. Automotive parts were up much more, by 43% in 1983. But unlike capital goods, automotive products also showed significant export gains, in part due to strong growth in Canada. U.S. car exports were up 45% to $4.2 billion, and parts were also up by 10%. However, the total increase in automotive product exports of 7% in 1983 was much less than the increase in imports.

The U.S. trade position in both consu-

mer goods and nonpetroleum industrial supplies worsened by about $6 billion in 1983. Imports of chemicals were up substantially by 14%, while exports were flat. The resultant loss of $1 billion still left the U.S. surplus at about $10 billion, compared to $12 billion in 1981. Textiles, steel and nonferrous metals all experienced substantial export declines, while paper exports were steady. All these products except steel also saw rises in imports, though in textiles the increase was only 6.7%. Total steel imports fell almost 30% for the year as a whole, but imports rebounded rapidly in the last quarter. In the sub-category of steel mill products, imports from less-developed countries appear to have taken much of the market share left by voluntary quotas and restraints on products shipped from Europe and Japan.

Among major nonelectronic consumer items, clothing imports increased by 17% in 1983, but imports of toys, games and sporting goods actually fell by 10.3%. Overall, consumer products imports increased by over $5 billion (13%) while exports declined by nearly $1 billion (6.3%).

Import penetration rises substantially in high-technology ~~electronics~~ fields. The declining competitiveness of U.S. manufactured goods, and particularly the impact of the dollar exchange rate, can be seen in increases in imports as a share of domestic U.S. consumption. Business cycle developments alone would only cause imports to increase along with the general rise in growth as the economy pulled out of the 1981-82 recession. But in many important areas the Commerce Department's 1984 Industrial Outlook estimates a dramatic rise in levels of import penetration that were already on the increase over the previous decade (*figure 3*).

It is quite clear that foreign producers are targeting high-growth, high-tech areas for their marketing efforts, particularly electronic products. Thus, in several machinery product groups where both recovery of U.S. demand and longer-term growth is slow, import penetration actually fell from 1981. Imports also fell or were stable in products affected by voluntary or mandatory quotas—textiles, steel and cars. But the U.S. experienced substantial increases of penetration almost across the board in electronics product categories. For example, in computers, while the market share of imports doubled between 1972 and 1981 from 3.5% to 7.1%, between 1981 and 1983 it increased to an estimated 12.7%. In office equipment, where imports have long been a major factor, the share increased from 20.3% in 1981 to an estimated 27.2% last year. Relatively speaking, the most spectacular rise is in telephone and telegraph equipment—from just 2.1% in 1972 to 4.1% by 1981, then to 9.1% by 1983. The continued rise of foreign-produced semiconductors to an estimated 37.4% of total domestic consumption is also noteworthy.

About the only hi-tech sector in which foreign import penetration significantly declined was aircraft. However, in aircraft equipment (excluding engines), import penetration rose by over a quarter, from 18.4% to 23.5%. The business cycle argument can certainly explain a rising level of the absolute value of imports, but such significant increases in market penetration over the past two years are obviously linked to the dollar exchange rate problem and lower production costs for those who manufacture abroad.

Regional Trade Patterns

Despite all the attention given U.S. trade competitiveness with Japan and the East Asian countries, the most serious problem in 1983 was continued worsening of U.S. trade performance with areas where the U.S. has had large surpluses in recent years, especially the European Community and Mexico (*see table 4*). As late as 1980, the U.S. trade surplus of over $16 billion with the EC more than covered our deficit with Japan. But falling exports and rising imports through last year contributed to a net $1.6 billion U.S. trade deficit in 1983 with the EC. In 1983, U.S. exports to the EC fell by $3.6 billion despite higher growth in the EC, while U.S. imports from the EC increased slightly. Similarly, the effects of the collapse of the peso led to a halving of our exports to Mexico in just two years, and a worsening of our trade balance by nearly $12 billion since 1981—while imports from Mexico have risen by $3 billion since 1981, exports have fallen almost $9 billion in value. The Council of Economic Advisers' report projects that Latin America's debt problem will affect U.S. trade performance with this region enough to account for almost 20% of the expected 1984 trade deficit.

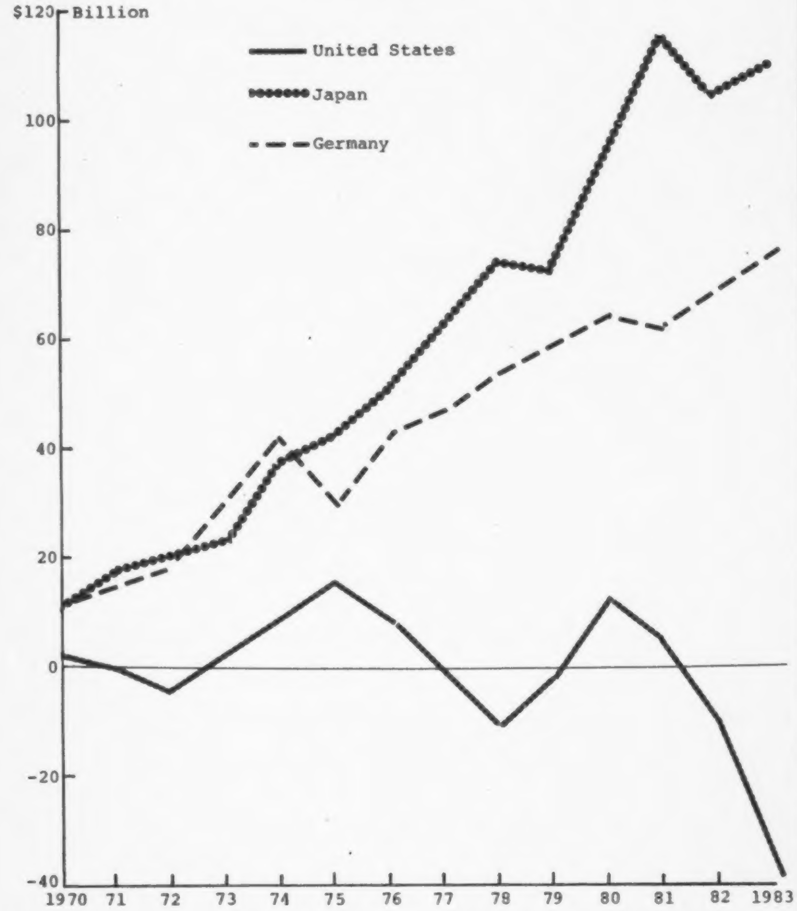
With Canada, East Asia and Japan, U.S. exports in 1983 increased over 1982, but the net trade deficit worsened with each because of rising U.S. imports. U.S. exports to Canada rose by $4.5 billion, but imports from Canada increased by $5.7 billion, reflecting high growth levels on both sides of the border. U.S. exports to Japan and East Asia increased in 1983, but only slightly, while U.S. imports increased substantially: $3.7 billion from japan and $6.1 billion from East Asia. This led to a material increase in U.S. bilateral trade deficits that were large to begin with: $21.7 billion with Japan and $13.7 billion with East Asia.

Despite large savings in oil imports, the U.S. trade balance with the OPEC countries actually deteriorated in 1983. U.S. imports from OPEC in 1983 were only half 1981 levels, and substantially lower than 1982—representing a total import saving of over $25 billion over 1981 imports. But the flip side of this coin is a fall in U.S. exports to OPEC. These exports actually increased in 1982, in spite of a world-wide decline in trade. But in 1983, U.S. exports to OPEC fell by a total of $8 billion, leading to a worsened trade deficit with OPEC.

Finally, the U.S. trade balance in 1983 also worsened significantly with developing countries outside of OPEC, East Asia and Mexico. In 1982, exports to these countries fell, but this loss was offset by a similar fall in imports. In 1983, U.S. exports fell a further $1 billion, while imports rose $2.7 billion. The result was that a near balance in 1982 became a U.S. deficit of $4.5 billion in 1983. ■

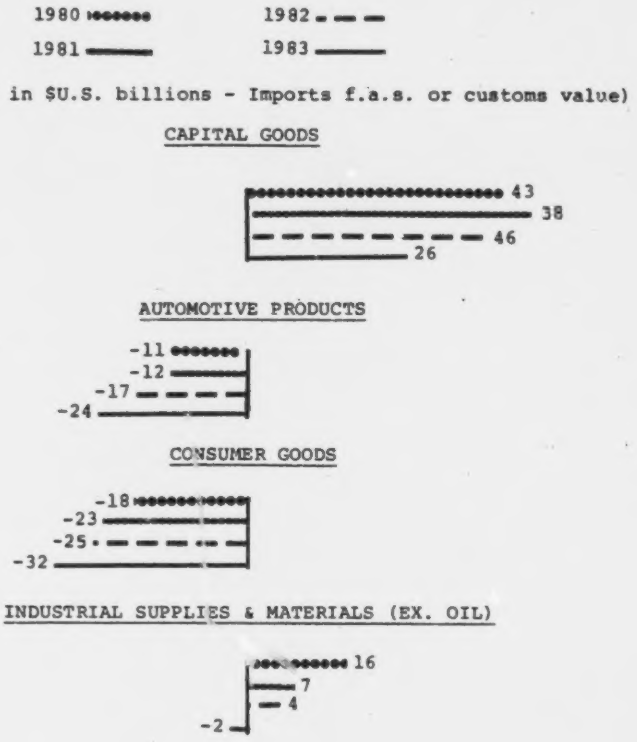
Figure 1: U.S., JAPANESE AND GERMAN MANUFACTURES TRADE BALANCES,

1970 - 1983



Imports c.i.f., except U.S. 1971-74. German and Japanese balances for 1983 are projections based on data through November. Source: U.S. Department of Commerce, International Economic Indicators, and national trade data.

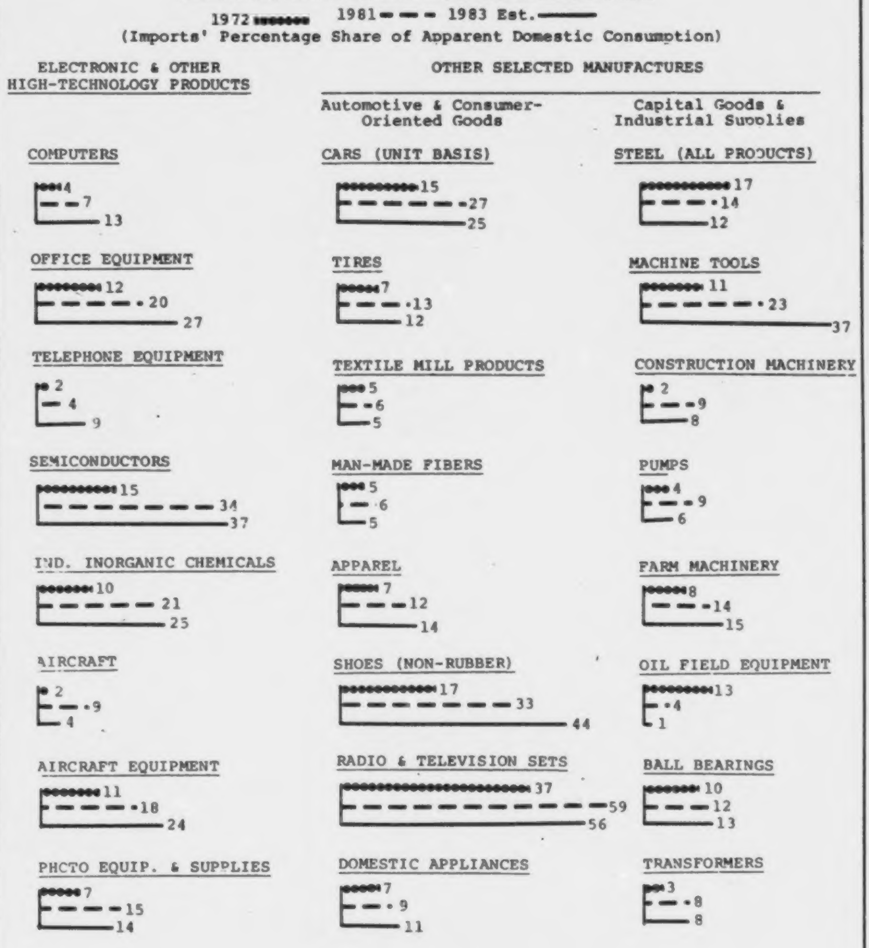
FIGURE 2: MAJOR SECTORAL BALANCES IN U.S. MANUFACTURES TRADE


(All figures in $U.S. billions - Imports f.a.s. or customs value)

Source: U.S. Department of Commerce, Highlights of U.S. Export and Import Trade.

Figure 3:

Import Penetration: Selected Product Categories



Source: U.S. Department of Commerce, 1984 U.S. Industrial Outlook

Table 1:

U.S. TRADE BALANCES AND EXCHANGE RATES WITH JAPAN AND EUROPE

	Trade Balances ($Bil.)			Currency Unit/$U.S.		Chg. in Currency Exchange Rate
	1980	1983	Chg.	Jan. 1, 1981	Jan. 1, 1984	
JAPAN	- 12.2	-21.7	- 9.5	¥ 203	¥ 232	- 14.2%
GERMANY	- 1.3	- 4.5	- 3.2	DM 1.96	DM 2.73	- 39.3
FRANCE	2.0	- 0.3	- 2.3	FF 4.52	FF 8.34	- 84.5
U.K.	2.5	- 2.3	- 4.8	£1 = $2.39	£1 = $1.45	- 64.8
ITALY	0.8	- 1.9	- 2.7	L 931	L 1657	- 78.0
E.C. TOTAL	16.4*	- 1.6	-18.0			

* - Includes Trade with Greece

Change in Currency Exchange Rate
Source: International Monetary Fund: International Financial Statistics
Department of Commerce: Highlights of U.S. Export and Import Trade

TABLE 2: U.S. EXPORTS - MAJOR PRODUCT CATEGORIES, 1982 -1983

PRODUCT GROUP	1982- Total Exports	1983- Total Exports	% Change
TOTAL Exports	$212.3 Bil	$200.5 Bil.	- 5.6%
Agricultural Exports-Total	37.0	36.5	- 1.4
Manufactured Exports-Total	139.7	132.4	- 5.2
Food & Similer Products (SITC 0-1-4)	28.5	28.4	- 0.4
Industrial Raw Materials (2)	19.2	18.6	- 3.1
Mineral Fuels (3): Petroleum & Products	5.9	4.6	-22.0
Manufactured Goods - Chemicals (5)	19.9	19.8	- 0.5
Basic Manufactures (6)	16.7	14.9	-10.8
--Paper	2.7	2.6	- 3.7
--Textiles	2.8	2.4	-14.3
--Iron & Steel	2.2	1.5	-32.2
--Non-Ferrous Metals	1.8	1.6	-11.1
Machinery & Transport Eqpt. (7)	87.1	82.6	- 5.2
--Power-Generating Machinery	9.5	8.7	- 8.4
--Agricultural Machy. & Tractors	2.4	1.6	-34.4
--Construction & Spl. Purpose Machy.	10.6	7.5	-29.2
--Machine Tools	1.6	1.1	-31.2
--General Industrial Machinery	9.9	8.0	-19.2
--Office Machines & Computers	10.2	11.7	14.7
--Electrical Machinery & Parts	11.3	11.9	5.3
--TV-Radio-Sound/Video Recorders & Other Telecom. Equipment	3.9	3.9	- 2.6
--Cars	2.9	4.2	44.8
--Automotive Parts	3.0	3.3	10.0
--Aircraft & Parts	11.8	12.2	3.4
Misc. Manufactures (8)	16.0	15.2	- 5.0
--Professional, Scientific & Controlling Instruments	6.0	5.9	- 1.7
--Clothing	1.0	0.8	-20.0
--Toys, Games & Sporting Goods	1.0	0.9	-10.0
Other Commodities (9)	6.9	7.0	1.5
By "End-Use" Definition -			
Capital Goods	72.7	67.2	-7.6
Automotive Products	15.7	16.8	7.0
Consumer Goods	14.3	13.4	-6.3
Industrial Supplies & Materials (Excluding Petroleum)	55.5	51.7	-6.9

Source: Department of Commerce, Highlights of U.S. Exports and Import Trade

Table 3: U.S. IMPORTS - MAJOR PRODUCT CATEGORIES, 1982 - 1983

(Imports at Customs Value)

PRODUCT GROUPS	1982 - Total Imports	1983 - Total Imports	% Change
TOTAL IMPORTS	$ 244.0 Bil.	$ 258.0 Bil.	5.7%
Agricultural Imports - Total	15.4	16.5	7.1
Manufactured Imports - Total	144.0	163.4	13.5
Food & Similar Products (SITC 0-1-4)	18.2	19.3	6.0
Industrial Raw Materials (2)	8.6	9.6	11.6
Mineral Fuels (3): Petroleum & Products	59.4	52.3	-12.0
Manufactured Goods - Chemicals (5)	9.5	10.8	13.7
Basic Manufactures (6)	33.1	34.8	5.1
--Paper	3.8	4.2	10.5
--Textiles	3.0	3.2	6.7
--Iron & Steel	9.6	6.8	-29.2
--Non-Ferrous Metals	5.3	7.4	39.6
Machinery & Transport Equipment (7)	73.3	86.1	17.5
--Power-Generating Machinery (incl. Engines)	4.5	5.3	17.8
--Agricultural Machinery & Tractors	1.0	1.2	20.0
--Construction & Special Purpose Machinery	3.5	3.7	5.7
--Machine Tools	1.9	1.5	-21.1
--General Industrial Machinery & Parts	4.8	4.8	0.0
--Office Machines & Computers	4.3	6.8	58.1
--Electrical Machinery & Parts	10.3	12.5	21.4
--TVs, Radios, & Sound/Video Recorders	4.1	5.3	29.3
--Other Telecommunications Equipment	4.9	6.0	22.4
--Cars	19.8	22.9	15.7
--Automotive Parts	4.4	6.3	43.2
--Aircraft & Parts	2.5	2.0	-20.0
Miscellaneous Manufactures (8)	28.1	31.7	12.8
--Professional, Scientific, & Controlling Instruments	1.7	1.9	11.8
--Clothing	8.2	9.6	17.0
--Toys, Games, & Sporting Goods	2.8	2.5	-10.3
Other Commodities (9)	7.7	7.7	0.0
By "End-Use" Definition:			
Capital Goods	35.4	40.9	15.5
Automotive Products	33.3	40.8	22.5
Consumer Goods	39.7	44.9	13.1
Industrial Supplies & Materials (Excluding Petroleum)	51.2	53.4	4.3

Source: U.S. Department of Commerce, Highlights of U.S. Export and Import Trade

TABLE 4:

U.S. TRADE WITH MAJOR REGIONAL TRADING PARTNERS, 1981-83

REGION OR COUNTRY	U.S. EXPORTS				U.S. IMPORTS (C.I.F. BASIS)				BALANCE			
	1981	1982	1983	Chg. 1981-3	1981	1982	1983	Chg. 1981-3	1981	1982	1983	Chg. 1981-83
CANADA	39.6	33.7	38.2	- 1.4	46.8	46.8	52.5	5.7	- 7.2	-13.1	-14.3	- 7.1
EUROPEAN COMM.	52.4	47.9	44.3	- 8.1	43.7	44.5	45.9	2.2	8.7	3.4	- 1.6	-10.3
JAPAN	21.8	21.0	21.9	+ 0.1	39.9	39.9	43.6	3.7	-18.1	-18.9	-21.7	- 3.6
MEXICO	17.8	11.8	9.1	- 8.7	14.0	15.8	17.0	3.0	3.8	- 4.0	7.9	-11.7
EAST ASIA*	19.6	20.2	21.5	1.9	28.0	29.1	35.2	7.2	- 8.4	- 8.9	-13.7	- 5.3
OPEC	20.7	24.9	16.9	- 3.8	51.8	32.7	26.5	-25.3	-31.1	- 7.8	- 9.6	21.5
OTHER LDCs	30.9	25.8	24.8	- 6.1	28.6	26.6	29.3	0.7	2.3	- 0.8	- 4.5	- 6.8
TOTAL TRADE	233.7	212.3	200.5	-33.2	273.4	254.9	269.9	-3.5	-39.7	-42.6	-69.4	-29.7

*Excluding Indonesia - Counted with OPEC

All Figures in Billions of Dollars

Source: Commerce Department, Highlights of U.S. Export & Import Trade

Chairman GIBBONS. Mr. Hermann.

STATEMENT OF RONALD B. HERMANN, VICE CHAIRMAN, MOTOR & EQUIPMENT MANUFACTURERS ASSOCIATION, AND PRESIDENT, GENERAL AUTOMOTIVE SPECIALTY CO., INC.

Mr. HERMANN. Mr. Chairman, members of the committee, my name is Ronald Hermann. I am president of General Automotive Specialty Co. We manufacture automotive parts in New Jersey and Alabama and we have a plant in Mexico as well.

Interestingly enough, in regard to Mr. Fox's remarks, which I will preface before my own, he spoke of the problems in export. In our own company, we did at one time export over 10 percent of our products and today the figure has dropped to 5 percent. Hopefully we will be able to hold that share primarily due to the reasons that have already been brought up.

I would like to introduce Mr. John Creamer, who is director of international trade for our association sitting on my left and will assist me showing you some charts.

On behalf of the Motor & Equipment Manufacturer Association which is the national association representing the manufacturers of motor vehicle parts, accessories and related products, I want to express our sincere appreciation for the opportunity of appearing before you today.

The more than 750 manufacturers which comprise our association produce virtually every product contained on, in, or used in the maintenance of both new and used cars, trucks and buses. Our member companies operate close to 2,000 facilities in nearly every State. In terms of employment, some 1 million people are involved in the production of motor vehicle parts, accessories, and equipment with a ripple effect which extends to literally millions of other workers.

Mr. Chairman, this marks the second time that MEMA has testified on world automotive trade before this committee. Just over 4 years ago, we appeared here to voice our concern over the alarming increase in motor vehicle parts imports which were riding on the coattails of Japanese automaker successes in the United States. At the time of our statement here in 1980, Japanese automobiles accounted for 15 percent of the cars in use on American roads and had taken 22 percent of the new car market.

American motor vehicle parts and equipment manufacturers were finding themselves shut out not only from the Japanese market, but also from an increasingly large share of the U.S. market. Specifically, Japanese car dealers in America were importing Japanese replacement parts to service their vehicles rather than purchasing U.S.-made parts of the same quality and often at a lower price.

MEMA project that "because of their increasing number and increasing age, (Japanese) vehicles will represent a market for replacement products that will nearly triple between (1980) and 1985." We felt that without access to the U.S. dealer network for Japanese cars, imported parts would account for the bulk of this expansion.

It should be noted, Mr. Chairman, that this testimony was presented before the first year of Japanese auto restraints before the dramatic appreciation of the American dollar, and before the impact of the international debt crisis. Despite the auto parts trade negotiations with Japan in 1978 and 1980, despite massive capital reinvestment in plant and equipment, despite improved international strategies, our industry has, for the first time in the 80-year history of our association, recorded a deficit in overall motor vehicle parts trade.

We have a chart here to illustrate the seriousness of this trend. You can see in the red over the black.

Our initial deficit is an impressive $1.55 billion. This situation worsens when you realize that the United States posted a $1.1 billion surplus with Canada, which brings the total deficit for U.S. motor vehicle parts, accessories, and equipment trade with all countries except Canada to $2.65 billion. Canada, as you can see, is a fair trade country.

Meanwhile, Japanese vehicle imports have increased to account for roughly 20 percent of the cars in use and nearly 30 percent of all new car sales in the United States. Japan is now the second largest exporter of motor vehicle products to the United States, behind Canada.

You can see the black represents what we are shipping to Japan and the red represents what Japan is shipping to us.

In 1983, Japan recorded another record year, shipping over $2.1 billion in parts and accessories to America. In spite of a Japanese pledge in 1980 to boost their automotive imports from the United States to $300 million, our industry exported just over $148 million in automotive goods to Japan last year. Consequently, Japan reaped an incredible $1.8 billion surplus accounting for 68 percent of America's total motor vehicle parts trade deficit with all countries except Canada.

The remaining portion of our negative trade balance traces itself primarily to the virtual collapse of our traditional Latin American markets. Exports to all these countries declined last year. Exports to Mexico fell some 35 percent while shipments to Venezuela declined by half. Payments due on accounts in the latter were all, but nonexistent through October of last year.

Our manufacturers see two major factors in the deterioration of Latin markets. First and foremost, the strong American dollar has pushed our prices, in a relative sense, to such levels that even our country's reputation for high quality cannot overcome our customers' needs to economize.

If I were to speak for my own company, I would tell you that the trade with Latin America came to a standstill for most of 1983 because there were no dollars for them to purchase any parts despite a strong desire to do so.

So, no payments were made on past purchases, which is also another interesting, and obviously contributing, factor.

Second, the international debt crisis and subsequent austerity measures have made dollars very difficult to obtain, particularly at an adequate exchange rate. Because of the strong dollar, developing countries further find their exports bringing in fewer dollars with which to service their enormous debts.

The strength of the dollar and the burden of foreign debts have forced many nations to promote, if not mandate, increased exports while virtually banning imports. The classic illustration is Mexico, which unfortunately is our industry's second largest export market, which we have a chart to illustrate. The effect of Mexican austerity has been dramatic: In 1981, the United States enjoyed a $1.5 billion surplus; in 1983, we recorded a $442 million deficit.

Again, in our own company, which is a relatively small unit in the scheme of things, in our Mexican facility we exported close to $1 million in the prior year of automated parts and in 1983 we had zero exports and were not paid because they were unable to get any funds out of the country.

MEMA believes that areas exist where private industry and the American Government should and must work together. Cooperation is essential to the establishment and maintenance of a fair and stable international marketplace.

The association believes that the U.S. Government must take steps to minimize pressures which are contributing to the unusual strength of the dollar. We applaud congressional efforts to reduce the Federal budget deficit, and thus, decrease the upward push on interest rates.

In a bilateral move, we urge that the U.S. Trade Representative's office continue to press the Japanese to further open their capital investment markets and to promote the internationalization of the yen. Strenghtening of the yen is particularly important to our industry because a strong dollar/weak yen combination has prompted overseas customers to switch to Japanese sources.

Interestingly enough, in our own company again, I can tell you that there were parts that were copied that we designed, manufactured in Japan, Taiwan, and Korea, that are subsequently shipped to all of our markets throughout the world identical to what we have except they are not identified. So since they are copies of what we have and if the salesman walks in and shows it to a customer, he believes it could be a U.S.-made part rather than a part made in Taiwan, Korea, or Japan.

In the area of international debt, MEMA believes that too great a price is being exacted on industrialized country manufacturers by severe austerity measures developed in accordance with the International Monetary Fund. We suggest that the international banking system should be held accountable for its part in the creation of the debt problem. More specific to our situation, we see our export opportunities dwindling while our import competition rises because of export promotion and import prohibition laws. These austerity programs illustrated by Mexico not only encourage American automakers to source more parts offshore, but in effect serve to bleed basic American industries in order to revitalize troubled developing countries.

I am sure I do not have to tell you the number of plants being built in Mexico to supply automotive component parts back to the United States because it has been well publicized, which of course means the loss of jobs in this country.

Finally, our industry is vitally concerned about our chronic inability to sell parts anywhere within the Japanese motor vehicle distribution system. We cannot sell in Japan, and now, because we are unable to supply parts for the Japanese car dealer network here, we cannot sell to a third of the American market. Moreover, although we were initially pleased to see Japanese automakers set up American facilities, we have since detected some disturbing trends in the sourcing choices of these plants.

For example, Honda Manufacturing in Ohio sources exhaust systems and seating from Sankei Giken Kogyo and Tokyo Seat Co. Nissan buys air-conditioning units from Nihon Radiator Co. and lighting equipment from Koito Manufacturing Co.

Again, I would like to refer to our own company where we have approached Tokyo and Nissan to be able to do business with them on the parts that we manufacture, and the attitude is that they pretend an interest; however, there is no interest and there is very little chance of success to penetrate this marketplace.

Preliminary indications point to similar sourcing by the GM-Toyota venture. These types of parts are readily available from American manufacturers. However, Japanese parts companies are hurrying to the United States and, in many cases, setting up facilities adjacent to their traditional manufacturers. Following a different pattern, the Yazaki Corp. has now set up facilities in Mexico which supply automotive wiring harnesses to Ford and Chrysler through their Foreign Trade Zone in El Paso, TX.

Our industry is not afraid of competition. In fact, the history of our industry is one of aggressive competition for automaker contracts. However, we have yet to see what we believe is a good faith effort by Japanese vehicle manufacturers to source parts from wholly owned American companies. To the contrary, we see Japanese parts companies using the new Japanese auto plants in the United States as bases for launching U.S. operations.

We have tried to present briefly our major concerns over motor vehicle parts trading as it exists in the world today. Many of our concerns are macroeconomic in nature and cannot be addressed by industry alone. But these problems must be addressed promptly. We are irretrievably losing markets steadily while imports continue to rise in the United States. Current trends indicate that increasingly large shares of the U.S. market will go to imports from Korea and Taiwan over the next decade.

If our industry is to meet the challenge from these developing countries as well as from Japan, we must maintain efficient production scales and adequate cash flows for reinvestment. We simply cannot do this while our markets deteriorate under pressures beyond our control.

Mr. Chairman, we appreciate this opportunity to present our concerns and we hope to work with this committee in developing solutions to the international trade problems confronting U.S. auto parts manufacturers.

Thank you. I would like to personally thank you for the opportunity of coming before this committee to express our views.

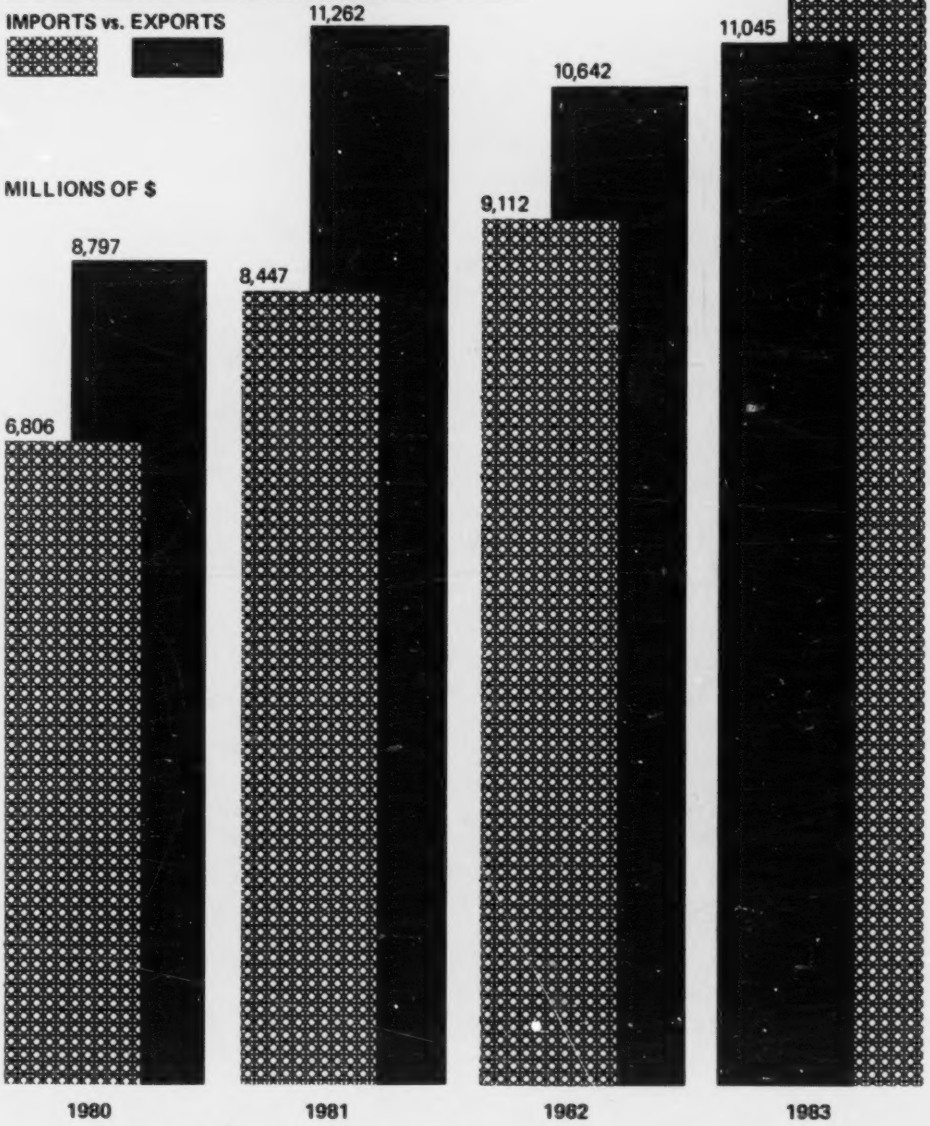
Thank you, sir.

Chairman **Gibbons**. Thank you, sir. We appreciate it.

[Attachments to the statement follow:]

U.S. MOTOR VEHICLE PRODUCTS TRADE

WORLDWIDE



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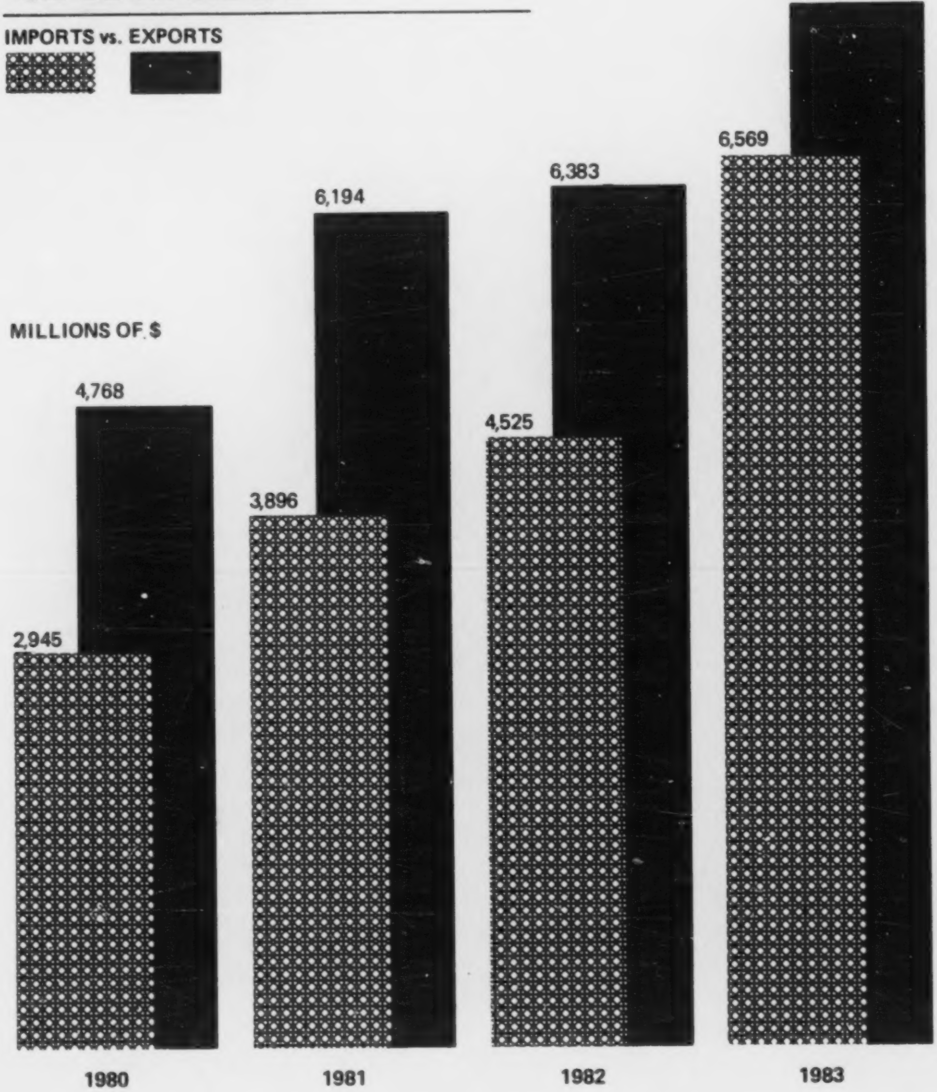
U.S. MOTOR VEHICLE PRODUCTS TRADE

CANADA



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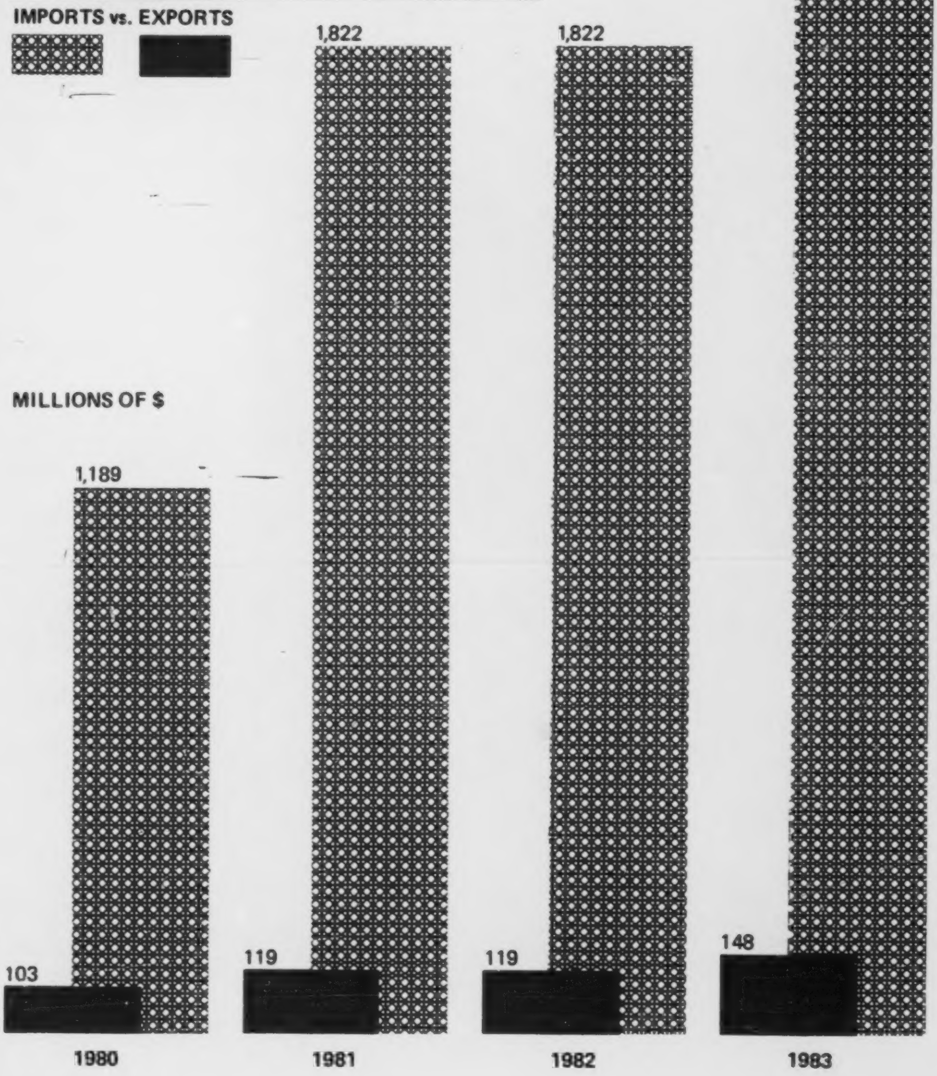
U.S. MOTOR VEHICLE PRODUCTS TRADE

JAPAN



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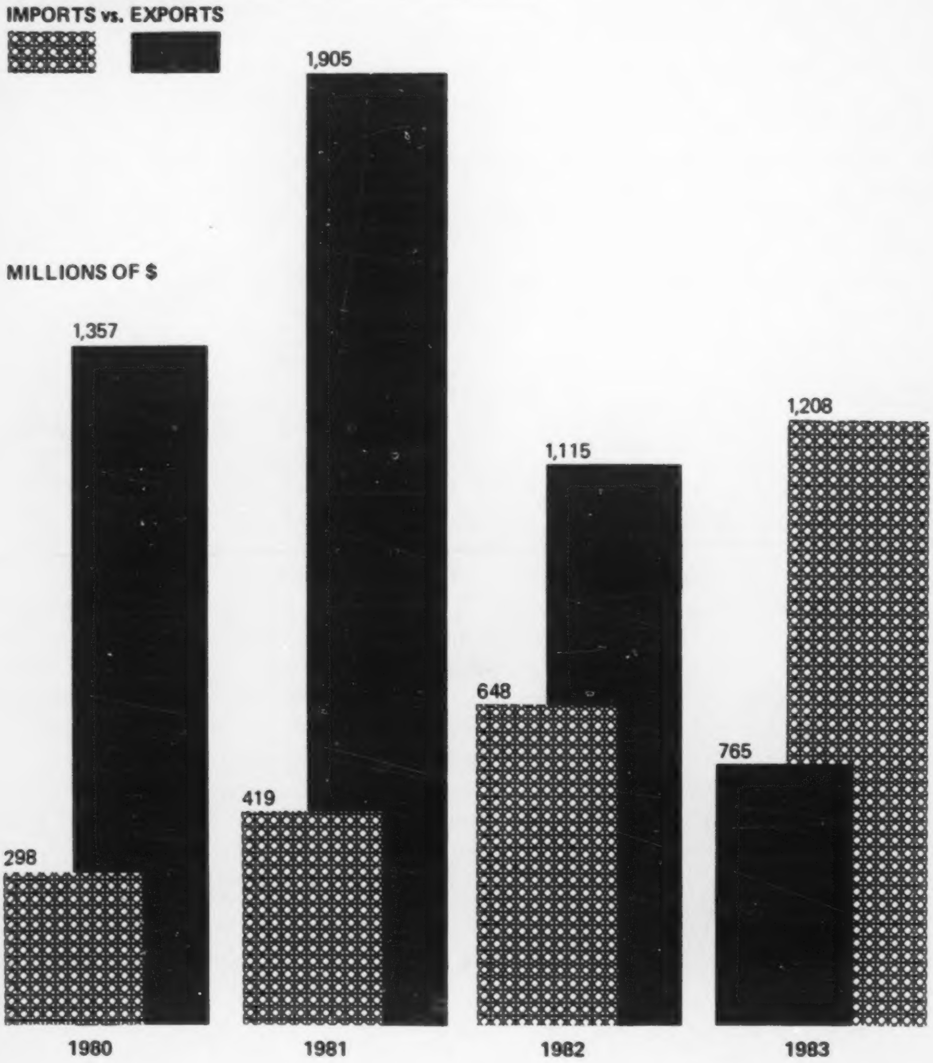
U.S. MOTOR VEHICLE PRODUCTS TRADE
MEXICO



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Chairman GIBBONS. And now, Mr. Roberts.

STATEMENT OF RICHARD W. ROBERTS, PRESIDENT, NATIONAL FOREIGN TRADE COUNCIL, INC.

Mr. ROBERTS. Mr. Chairman and members of the committee, I am Richard Roberts, president of the National Foreign Trade Council, an association of over 600 companies engaged in international trade and investment.

A written statement has been presented, and I respectfully request it be made a part of the record.

Chairman GIBBONS. Yes, sir. All statements today will be placed in the record.

Go right ahead.

Mr. ROBERTS. First of all, we strongly endorse the subcommittee's decision to hold hearings on the U.S. trade deficit.

International trade now accounts for about a sixth of the Nation's gross national product. Mounting trade deficits for 1984, expected to exceed $100 billion, are a clear signal that U.S. industries are encountering difficulties in competing in the international marketplace.

A congressional review of the causes of the trade deficit and possible actions our country can take to strengthen the competitiveness of U.S. industries is both timely and appropriate.

The main causes of the U.S. trade deficit have been identified as, one, a strong dollar; two, recessionary conditions in many parts of the world coupled with a recent accelerated growth of the U.S. economy; protectionism abroad; and, fourth, a decline in the competitiveness of U.S. goods and services. Let me briefly describe each.

The strong dollar: Effects of the strong dollar caused in large part by high U.S. interest rates are well known. U.S. products have become significantly more costly abroad and our imports have become relatively cheaper. The result is a decline in exports and increase in imports.

It is authoritatively estimated that between one-fourth and one-half of the current U.S. trade deficit is attributable to the high dollar.

Recessionary conditions abroad coupled with a rapid recovery at home and slow or negative growth rates abroad have a heavy adverse effect on our exports. By contrast, our recovery at home has spurred U.S. demand for goods and services of all kinds, resulting in a surge in imports.

The third item, protectionism. The worldwide recession has generated new protectionist pressures which have a very substantial adverse effect on U.S. exports. Policies of economic nationalism abound, emphasizing protection of the home market against imports and myriad forms of government intervention to expand exports.

Fourth, the decline in U.S. competitiveness. While many U.S. products are competitive in price and quality, others are not. A variety of factors including regulatory burdens and delays which adversely affect U.S. producers, insufficient emphasis on quality, excessive production costs and of course the high dollar have all impaired the competitiveness of U.S. industry.

Having identified the main causes of the trade deficit, let me briefly note some of the consequences. The familiar formula is that each billion dollars of exports is equal to 25,000 jobs. Thus, the 1984 trade deficit of $100 billion is substantially equivalent to 2.5 million jobs. In terms of GNP, if there had been no deficit last year our GNP would have been at least a percentage point higher.

On the other side of the ledger, imports which are less costly as a result of the strong dollar helped to reduce inflation and the U.S. purchases of the goods and developing countries assist them to buy U.S. goods and services and restructure their economies, reducing their dependence on multilateral assistance programs.

What can be done to reduce the trade deficit? The four main causes for the trade deficit just discussed are not immutable. Actions can be taken by American industry for the public and Government to address each of them.

Turning first to the high dollar, we believe that the reduction of the Federal budget deficit would help to bring about significantly lower interest rates which would in turn tend to reduce the exchange rate value of the dollar. The result over time would be an upsurge in exports and a gradual reduction in imports

We therefore strongly support action by the administration and the Congress to hold down interest rates by reducing Federal expenditures.

Recessionary conditions abroad: With respect to them, our ability to bring about change is limited. But we can assist developing countries to restructure and strengthen their economies through support of the IMF, through renewal of our generalized system of preferences legislation, and through U.S. leadership in international forums in advocating reduction of trade barriers. And in meetings such as the forthcoming London economic summit, the United States will be working with the principal industrialized countries on joint action to stimulate economic growth for all.

As to protectionism, we recommend that the U.S. Trade Representative negotiate vigorously and tenaciously to eliminate foreign trade barriers and bring more proceedings in the GATT to enforce internationally established trade rules. The United States should also press GATT members to adhere to its rules and consider how GATT procedures could be strengthened to more effectively redress unfair trade practices.

Section 301 of the Trade Act should be invoked more effectively. And in that context, we strongly urge that Congress proceed to enact provisions of H.R. 1571, the Reciprocal Trade and Investment Act, which would strengthen the President's powers under section 301 to negotiate reductions in foreign barriers of trade and investment.

Finally, U.S. competitiveness. U.S. industry has a major responsibility to improve quality and reduce costs and become more innovative. A recent recession at home and intensive competition abroad has been a powerful stimulus for management and labor to become more productive.

Recently, the decline in U.S. competitiveness has been attributable to foreign industrial policy that is, special protection given to industries and assistance to industries which generate export earnings. Proposed solutions include local content laws, import surcharges and broadening the definition of foreign government subsidies and U.S. trade laws, all with the objective of further sheltering U.S. producers from the effects of foreign competition.

We believe that trade expansion is best achieved through policies to increase exports rather than policies to limit imports, and therefore recommend that the Congress resist imposing broad new restrictions on imports.

The GATT and our own counterveiling duty and antidumping laws already address the most common unfair trade practices and section 201 addresses import surges. The enactment of new U.S. laws to penalize allegedly unfair imports is likely to include violations of the GATT and generate major conflicts with foreign governments which regard support of industry as a matter of national sovereignty and necessity.

In addition, the U.S. Government itself has provided a variety of forms of financial assistance to various industries. If foreign governments were to pass similar laws, some of our export markets would be in jeopardy. Moreover, protecting U.S. products in the domestic market tends to raise the price of the protected product and will not shelter U.S. industry in competition outside the United States.

We believe the most effective way to enhance the competitiveness of U.S. industry is neither to institute special government assistance programs for particular industries or sectors nor to impose further restrictions on imports but rather to adopt policies which strengthen the entire U.S. economy.

Broadly, these policies should address capital formation investments, technology, and human resources.

I will briefly describe these and then I am finished.

Capital formation and investment. Private capital investment in plant equipment and technology should be encouraged through policies which reduce investment disincentives and promote investments in more efficient plant and equipment.

In particular, incentives to encourage sales and investment in productive plant and equipment and technology will significantly enhance U.S. industries' ability to compete in international markets.

Second, maintaining leadership in technology. The United States has long excelled in science and technology, but action is needed to stimulate both the growth and dissemination of technology to enhance competitiveness.

Tax antitrust and patent laws should be amended to provide greater stimulation for R&D. Both at home and abroad, a stronger effort is necessary to protect intellectual property rights. Unreasonable regulatory delays and requirements which inhibit the utilization of new technology should be revised.

Education and training. The American work force must be better prepared to adapt to change. There is a shortage of workers adequately trained in science, engineering and mathematics. Millions of displaced workers must learn new skills. Disadvantaged workers whose basic education is inadequate must be assisted to meet the challenges of rapid change and new technology. A better educated, more productive work force should be a high-priority national goal implemented by a comprehensive joint business and Government program to upgrade the skills of workers at all levels.

In addition to the policies just mentioned aimed at strengthening economic growth, generally the following specific actions, some referred to previously in this statement would contribute significantly to export expansion and to reduction of the trade deficit. And let me say here that this is a very complicated area, as you, Mr. Chairman, suggested at the beginning. Therefore, our solutions are not single but rather go across a spectrum of actions and policies by the public, by labor, by government, by management.

What we recommend are the following: A continuing effort to combat protectionism by foreign countries. Encouragement of developing country efforts to strengthen their economies; reduction of the U.S. budget deficit which would lower the exchange rate value of the dollar; improvement of the competitiveness of U.S. goods and services through the removal of regulatory disincentives to exports; avoidance of domestic protection policies and adoption of laws and policies aimed directly at export expansion—for example, support of adequate financing for Eximbank and the continuation of DISC or an adequate substitute.

To conclude, we believe the trade deficit can be reduced significantly or eliminated over time. For its part, U.S. industry must continue its efforts to achieve greater efficiency and competitiveness. It can best do so if it operates within the framework of policies which are supportive of economic growth and are formed with a clear understanding that it is now the world marketplace in which U.S. industry now competes.

Thank you.

[The prepared statement follows:]

STATEMENT OF RICHARD W. ROBERTS, PRESIDENT, NATIONAL FOREIGN TRADE COUNCIL, INC.

The National Foreign Trade Council, an association of over 600 companies engaged in international trade and investment, strongly endorses the Subcommittee's decision to hold hearings on the critical issue of the U.S. trade deficit. Our nation's economic health is increasingly dependent on the ability of U.S. industry to compete in the international marketplace. It is essential that the public and policy makers become fully aware of the nature of the competitive challenges which we face, if wise policy choices are to be made.

CAUSES OF THE U.S. TRADE DEFICIT

As this Committee is well aware, on a balance of payments basis the 1983 trade deficit—the excess of imports over exports—was $60 billion. The 1984 trade deficit could hit $110 billion and will likely be still larger in 1985.

The principal causes of the deficit are:

(1) The strong dollar; (2) Recessionary conditions in many parts of the world, coupled with the recent accelerated growth of the U.S. economy; (3) Protectionism abroad; (4) A decline in the competitiveness of U.S. goods and services.

I will address each of these in turn.

First, the strong dollar.—There is no correct exchange rate value for the dollar, since the U.S. dollar is not pegged to gold or to any foreign currency. Using the average over the period 1973–79 as a base, the dollar has appreciated by one-third, according to the Council of Economic Advisers. Several factors have contributed to the strength of the dollar, and, as this Committee knows, there have been considerable differences among analysts as to the relative importance of each. One is the 'safe-haven' effect—political and economic instability in many foreign countries has caused capital to flow into the U.S. economy which is perceived as strong and stable.

Another is high U.S. interest rates: the attractive real, after-tax rate of return on U.S. investments has produced very substantial capital flows from abroad. High U.S. interest rates are themselves attributable to a number of factors: the most prominent is the Federal budget deficit; present and anticipated borrowing needs of the Federal government in competition with the borrowing needs of the private sector have maintained upward pressure on interest rates. The high budgetary deficits at a time of rising private credit demand increasingly conflicts with the monetary policies of the Federal Reserve Board, instituted to strike an appropriate balance between combating inflation and fostering orderly growth. The conflict has contributed to interest rates which, while considerably lower than a few years ago, are high by historic standards.

Second, the worldwide recession, coupled with the strong recovery of the U.S. economy.—Slow or negative growth rates in countries which are major customers for U.S. goods and services, particularly developing countries burdened with high debt, have had a heavy adverse impact on our exports. For example, according to the report of the Joint Economic Committee, exports to eight high-debt Latin American countries fell by 27 percent from 1982 to 1983.

And in OPEC countries, reduced oil revenues have cause modifications of development programs and significantly reduced purchases of U.S. products.

In 1983, overall, the United States experienced a 5.5 percent drop in export values from 1982.

On the other hand, the U.S. economy has surged. While growth for the rest of the world in 1984 is estimated in the 3-4 percent range, U.S. growth is expected to be over 5 percent. This means that U.S. demand for imports will be growing much faster than foreign demand for U.S. exports. While the growth in the U.S. economy is most encouraging for domestic producers and helps the economies of many countries, particularly debt-ridden developing countries, the effect on the U.S. trade balance is negative.

Third, protectionism abroad.—The worldwide recession has generated protectionist pressures, as country after country seeks to preserve its home market for domestic producers. In addition, national industrial policies, effected through state-owned corporations, export subsidies and home-market protection, endeavor on the one hand to expand markets abroad and on the other to limit import competition.

While it is difficult to put a price tag on foreign government protectionist policies in terms of their effect on U.S. trade, it is fair to say that U.S. exports would increase very substantially if the multitude of overt trade barriers were removed.

Fourth, the decline in U.S. competitiveness.—By competitiveness I refer not only to the price of U.S. goods and services but also to their overall quality, conformity to specifications, and such allied considerations as timeliness and reliability of delivery and availability and reliability of post-purchase service.

Although American products continue for the most part to enjoy a high reputation at home and abroad, there is abundant evidence that some American products are of mediocre quality, are poorly adapted to use abroad, and are too costly in comparison with competing products. The problem of high production costs and inadequate quality control in particular are matters of concern in industry after industry.

Another major burden on the competitiveness of American goods and services is the regulatory environment. Disincentives to exports, including unrealistic provisions of the Export Administration Act, the Foreign Corrupt Practices Act, and statutes with commendable but overreaching safety, environmental and health objectives have increased the cost of U.S. goods and services and reduced the ability of U.S. industry to compete on an equal footing with foreign competitors.

Having identified the principal causes of the trade deficit, let me now identify some of the consequences of the deficit for our economy.

First and foremost, lost revenues which translate into lost business opportunities and lost jobs. The familiar formula is that each billion dollars of exports is the equivalent of 25,000 jobs. Roughly, then a trade deficit of $100 billion equals 2,500,000 jobs. Another way of measuring the effect of trade on our economy is to consider its effect on the gross national product. As recently as 1970 exports and imports together accounted for about 12 percent of the GNP. By 1980 trade (both ways) accounted for over 18 percent of our GNP, which means that we are increasingly part of an interdependent international economic system in which we must successfully compete unless we are prepared to accept the role of a second class economic power with an attendant lower standard of living.

Another, very serious consequence of the trade deficit is an increase in domestic protectionist pressures. American firms which are hard hit by foreign competition increasingly request our government for protection. Cries are heard for orderly marketing agreememts, tariffs, and expanded countervailing duty statutes to combat perceived unfairness by foreign producers. Protectionist actions by the United States generate or justify protectionist by our trading partners, which adversely affects U.S. exports.

On the other side of the ledger, there are important benefits to the U.S. economy resulting from the high current level of imports. The first is the reduction in the cost of living which results from low-cost imports. The strong dollar enables U.S. purchasers to acquire foreign products at prices which may be up to 30 percent lower than three years ago. A second positive effect is that the present high level of imports significantly buttresses the economies of a number of developing countries which depend heavily on exports to the United States to generate the necessary funds to pay interest on outstanding debt and to purchase U.S. products and services needed to regenerate their own economies. In the absence of exports to the United States many developing countries would become more dependent on multilateral lending institutions and on direct assistance programs of the industrialized countries for help.

A third positive effect of the deficit is that it puts downward pressure on the dollar. As the United States spends more for imports than it receives for its exports, more dollars are received and held abroad, and the demand for dollars declines in international markets. In spite of this effect, high U.S. interest rates have continued to serve as a magnet for foreign funds, helping to maintain the dollar at historic highs and counteracting the normal adjustment process just referred to.

Having reflected on some of the causes and consequences of the U.S. trade deficit, let me discuss some of the steps which are necessary to reduce it.

One important step would be to begin the process of reducing the relative value of the dollar in an orderly manner. A major cause of the strong dollar is high interest rates generated by an unprecedented peacetime Federal deficit. Reductions in entitlement programs and military spending are required, together with selective tax increases. The job of choosing programs to be cut, and searching for increased tax revenues, is a painful but necessary responsibility of the Congress, now taking place. Also, action by Japan to internationalize the yen would reduce the world demand for dollars.

Even if the dollar became progressively less strong, however, that development alone would not be sufficient to restore U.S. exports to satisfactory levels. Until economic growth in other nations, particularly in the developing world, resumes an upward path, there simply will not be a market abroad for all the U.S. products which we desire to export and which many countries so desperately need. The management of the economics of the developing world is outside our control, but we can encourage developing countries to reduce their debt and restructure their economies by paying our fair share of the funds needed by the International Monetary Fund and multilateral development agencies to provide the necessary loans to developing countries. In addition, the United States must maintain the Generalized System of Preferences and take the lead in reducing trade barriers which impede developing country exports. It is now a well known fact that 40 percent of U.S. exports of manufactured goods are purchased by developing countries; unless we are willing to buy their products and participate in efforts to strengthen their economies, that export market will continue to falter. Finally, a reduction in U.S. interest rates would reduce the debt obligations of many developing countries, thereby strengthening the market for U.S. exports.

Another important step which the United States can take to reduce the trade deficit is to bring greater pressure to bear on our trading partners to eliminate protectionist barriers to trade. Foreign protectionist policies are instituted for a variety of reasons: as a component of a nation's industrial policy; to protect a home market; to protect declining industries; or as an austerity measure to address balance of payments difficulties. Most often, protectionism, put simply, is a failure of adjustment: it is a fact of life that many nations and groups within those nations are unable or unwilling to transfer resources from uneconomic or marginally profitable activities into other activities.

What can the United States do to stem foreign protectionist pressures? The effort must proceed on several fronts simultaneously and it must be unceasing. First, in international organizations and forums such as the economic summit meetings, the OECD and the General Agreement on Tariffs and Trade ministerial conferences, the United States must work to establish stronger commitments by the parties to reduce or eliminate protectionist barriers. Because the GATT constitutes a set of internationally agreed rules to discourage tariff and non-tariff barriers to trade, the GATT should be strongly supported by the United States. Because the GATT is primarily a consensus organization with limited enforcement powers, the United States should work to strengthen GATT's enforcement powers and also to press other GATT nations to enlarge the GATT rules to cover trade in services and high technology. Gradually, too, through the GATT or some other multilateral institution, rules must be formulated to reduce investment restrictions which not only impede trade but also operate as barriers to open markets.

Second, the United States and U.S. producers legally empowered to do so should continue to invoke and enforce domestic U.S. trade laws, which prohibit, among other things, the importation of dumped or subsidized goods. These trade laws discourage other countries from certain forms of unfair trade competition and through the mechanism of countervailing or antidumping duties eliminate the effect of dumping or overt subsidies in the U.S. marketplace. But the U.S. trade laws do not, in our opinion, provide an effective long-range answer to the problem of restoring the competitiveness of U.S. industry or the reduction of the trade deficit. Among other reasons, our trade laws apply only to domestic imports and therefore do not protect U.S. producers in third country markets. If U.S. industry is to compete successfully in third country markets it must be prepared to meet the competition of products and services from countries which provide government assistance to domestic producers; the alternative is to forego the opportunity to operate on a world scale.

In addition to the GATT and the trade laws, bilateral trade negotiations offer an important avenue for reducing barriers to trade. Determined, persistent negotiating efforts by the USTR and the Commerce Department, and other Departments and agencies, have defused trade conflicts and effected reductions in foreign protectionism. Such negotiations should be continued and indeed accelerated both to reduce the current trade deficit and to maintain an open international trading system.

FOREIGN GOVERNMENT INDUSTRIAL POLICY AND TARGETING

Some representatives of the business community and of organized labor maintain that a significant cause of the trade deficit is foreign government assistance to particular industries, commonly known as "targeting," which is alleged not to be addressed by existing U.S. trade laws. Those holding this view have proposed antitargeting legislation as the solution—penalizing imports where there has been demonstrable foreign government support for specific products.

Others in the business community remain skeptical of the wisdom of such legislation, arguing that it is thinly disguised protectionism, and that the real difficulty is that many leading U.S. corporations have become uncompetitive, giving inadequate attention to product quality and innovation, and placing overemphasis on short-term results. But even if proponents of antitargeting legislation can document cases where foreign government assistance to particular industries has conferred a competitive advantage on some foreign products, the United States cannot reasonably anticipate that domestic antitargeting legislation or negotiation, either at the multilateral, bilateral or unilateral levels, will significantly diminish the practice, for several reasons.

First, government intervention in the marketplace is a fact of life in many countries, sometimes buttressed by a socialist philosophy, sometimes as a response to pressing economic needs. The motivations cross a broad spectrum. But for many nations government support of particular sectors, or involvement through state-owned corporations, is a cherished right—even if it may prove an economically inefficient procedures. Hence efforts in the GATT or in one-on-one trade negotiations to eliminate targeting are unlikely to succeed, although some practices, akin to subsidization or dumping, may eventually be barred.

Secondly, even if the United States were to penalize targeted products at our own borders, we cannot expect to restrain targeting in the international marketplace.

Thirdly, a complicating factor is that the United States government provides support to a number of industries which constitutes a form of targeting and which the United States would be obliged to discontinue, at the risk of losing foreign markets for such products.

While it is important to identify foreign government targeting practices and to consider how such practices could be restrained, the membership of the National Foreign Trade Council believes that the best solution to the problem of foreign government targeting—and indeed to the trade deficit itself—lies in a multifaceted effort to create an economic environment in the United States which encourages growth and adaptation to new challenges.

We do not believe that such an economic environment will result from the adoption of an industrial policy, under which our government in consultation with business and labor groups would identify industries and companies worthy of special assistance and support. Our two main reservations about this approach are:

First, we are dubious about the ability of government officials, or a council of business, labor and government representatives, to successfully identify industries or companies which offer special economic promise. Industrial policy has been, by and large, a failure in Europe for the past decade and even in Japan the results of government support have been highly uneven. Such decisions are best made in the marketplace, which history has proved to be the most effective method of resource allocation.

Second, we believe that any industrial policy developed would, under the American political system, be shaped to reflect social, regional and other goals in addition to economic goals with the result that industrial policy would become another politically oriented form of entitlements program.

The following macroeconomic policies are recommended to strengthen the U.S. economic environment and enhance the competitiveness of U.S. industry:

1. Capital formation and investment.—Private capital investment in plant, equipment and technology should be encouraged through policies which reduce investment disincentives and promote investments in more efficient plant and equipment. In particular, tax incentives to encourage savings and investment in productive plant, equipment and technology will significantly enhance U.S. industry's ability to compete in international markets.

2. Maintaining leadership in technology.—The United States has long excelled in science and technology, but action is needed to stimulate both the growth and the dissemination of technology as a means to enhance competitiveness. Tax, antitrust and patent laws should be amended to provide greater stimulus for research and development. Both at home and abroad, a stronger effort is necessary to protect intellectual property rights. An unreasonable delays and requirements which inhibit the utilization of new technology should be revised.

3. Education and training.—The American workforce must be better prepared to adapt to change. There is a shortage of workers adequately trained in science, engineering and mathematics. Millions of displaced workers must learn new skills. Disadvantaged workers whose basic education is inadequate must be assisted to meet the challenges of rapid change and new technology. A better educated, more productive workforce should be a high priority national goal implemented by a comprehensive joint business-government program to upgrade the skills of workers at all levels.

In summary, the persistent trade deficit is a clear indication that U.S. industry is not fully competitive in the international marketplace and that there is a need for change in U.S. economic policy. There is no single, simple solution. In addition to policies just mentioned aimed at strengthening economic growth generally, the following specific recommendations, made earlier in this statement, would contribute signficantly to export expansion and reduction of the trade deficit:

A continuing effort to combat protectionism by foreign countries.

Encouragement of developing country efforts to strengthen their economies.

Reduction of the budget deficit, which would lower the exchange rate value of the dollar.

Improvement of competitiveness through removal of regulatory disincentives to exports.

Avoidance of domestic protectionist policies.

Adoption of tax policies which foster trade and investment rather than impede U.S. competitiveness.

To conclude, we believe that the trade deficit can be signficantly reduced or eliminated over time. For its part, U.S. industry must continue its efforts to achieve greater efficiency and competitiveness. It can best do so if it operated within the framework of policies which are supportive of economic growth and are formed with a clear understanding that it is the world marketplace in which U.S. industry now competes.

Chairman **Gibbons**. Thank you, sir.

Mr. Hermann, did I understand you correctly to say that Japanese producers or foreign producers of parts are coming into this country following plants into this country?

Mr. **Hermann**. Yes, sir, that is correct.

Chairman **Gibbons**. That is interesting.

Why, with the dismal picture you painted here, if it is dismal, why would they want to invest their capital in this country where they would be using our same raw materials, our same labor that we are having such a terrible problem with right now? Why would a foreigner want to put a plant in the United States with this kind of picture that you show here in these charts?

Mr. **Hermann**. If I could draw upon my personal experience, Mr. Chairman, I think it would best illustrate the point. Having been in Japan and attempted to penetrate the Japanese auto manufacturers as a supplier of particular components that we currently manufacture in this country and do supply to our own motor car companies, we were met with a stone wall. That best describes the situation.

The Japanese car manufacturers have a family. The family consists of not only the assemblers but the parts suppliers as well. They live in the same community. They supply the parts. They have a very efficient system of doing so. They are very comfortable working with their own.

The idea of their coming to this country if they are able to use as a base initially the assembly plants and then begin to supply them with their own parts, they can, in fact, set up a manufacturing operation here with a market already in place. That is the first market.

The second market is the one of deep concern to us and that is the replacement market. You will recall in my talk that I mention that we are unable to penetrate the dealer network.

In our own company we manufacture many parts for Japanese cars but we are unable to sell any of these parts to the Japanese dealer network and our parts, in many cases, are far superior to what has already been supplied by their own parts manufacturers in Japan. We know that because we have thoroughly tested the parts.

So basically the reason is that they have a close family and they are going to keep it that way and they see a way not only to develop their own industry at our inspection. They will employ American workers, that is true. However, the parts that they are going to be manufacturing and the profits that they will make will go back to Japan and will not be part of our own economy.

Chairman **Gibbons**. Well, am I to assume that their parts to these companies will cost the same as yours and have the same characteristics?

Mr. **Hermann**. I would assume that if they are able to set up a manufacturing facility here that they would have comparable costs as we do. Maybe higher costs initially because you have to remember that if you are going to make a huge capital investment, that becomes part of your cost of doing business.

We do have the facilities to service what they are doing today. The American parts manufacturers make good parts. They make the parts competitively priced. We have sold for years throughout the world. We have an excellent reputation. There is no reason why we cannot sell these parts to Japanese manufacturers, except for the fact that there seems to be a policy, written or unwritten, that prohibits us from doing it.

Chairman **Gibbons**. Well, now, as to the dealer network, is there something in the contract between the foreign auto dealer in the

United States and his supplier overseas that inhibits him from purchasing parts from you?

Mr. HERMANN. To the best of my knowledge, Mr. Chairman, I honestly could not say if there is a written agreement or not but a dealer who is selling Hondas or Toyotas or Datsuns in this country would be told that "we would like you to use our parts." If you are the dealer and your dealership would be in jeopardy if you went out and bought parts on the outside, the likelihood is that you would do what you were told to do whether it is written or not.

The fact is that we cannot sell them. That is a fact.

Chairman GIBBONS. There is no argument about that. I'm just trying to find out what you think the problem is.

Mr. HERMANN. It is interesting too, because when the Japanese auto-parts manufacturers sell directly to the motorcar companies in Japan for original installation, they sell as we do at very low cost. Maybe they even give it away below their cost.

So what they are doing is, they are opening up this market for replacement to make up the profit that they lose by selling to the car assembly operations in Japan.

So it is an opportunity that the car manufacturers give them to sell additional replacement parts in the United States at much higher prices than they would if they only had the Japanese autocar manufacturers as customers.

Chairman GIBBONS. Mr. Roberts, I see you are pretty concerned about that little old bill of mine that tries to enforce what I thought we had agreed to in GATT 40 years ago and agreed to in the subsidies code just 5 years ago.

I don't share your deep concern, although I must say we have to see how it works out. I would imagine your council doesn't condone these foreign subsidies, do they?

Mr. ROBERTS. No, we do not condone them. However, it is becoming increasingly clear as we look at foreign government attitudes toward assisting industry, that there is an enormous spectrum of views and actions by governments relating to domestic industry. Some feel that it is a sovereign right, that indeed it is one of the most important purposes of government.

Chairman GIBBONS. It is a part of the sovereignty that we gave up when we signed GATT, and all governments gave up when they signed GATT, that we wouldn't subsidize. I don't understand your position. We all surrendered a bit of our sovereignty. We can't sign something and then just abide by what we like. If we sign something, we abide by the whole spectrum of the restraints and the advantages that are in it.

Mr. ROBERTS. Well, there is no real disagreement between us on that issue, Mr. Chairman. We feel strongly that the GATT subsidy code should be enforced, and the U.S. laws which are intended to supplement that should also be enforced.

Now the difficulty, as we see it, is that the GATT subsidy code does not go by any means far enough. It is extremely limited in the practices that it prohibits. There are big holes in it. It does not address some of the problems which your bill endeavors to address, which are forms of foreign government assistance which are not, directly speaking, subsidies. These are disguised subsidies or much more subtle ways of giving assistance to foreign companies that have export potential.

So that we do agree that the GATT prohibition against the subsidies is important. What we are concerned about is, very simply, that we are creating new trade sins not covered by the GATT, and we are saying to the rest of the world yes, these are the no-nos; these are the unfair practices which we in the United States believe should be eliminated; and the difficulty, of course, is that in the eyes of many countries in the world, these are not considered unfair practices, they are not considered to be covered by the GATT, and therefore we have this conflict of economic philosophy.

Chairman GIBBONS. I heartily disagree with you there. When we went into the GATT, we took our countervailing duty laws as part of our right under GATT, and it was any bounty, or any subsidy, or any payment.

Now the bounty is a pretty broad description of what would be prohibited, and bounties are bestowed in wondrous ways and always have been, but it is not an attempt to just limit the cash subsidies.

Now some of these governments would like to limit it just to cash grants. The definition, from my study of the history of our subsidy laws, has never been limited to that, and I just disagree with you on that purpose.

As I look at it, you know, America has two choices. We can either have a fair but vigorous enforcement of anti-subsidy laws, or we can join in the subsidy battle. We can outsubsidize everybody else on the face of the earth, and we'd win that battle because we have got more resources, but what would the American economy look like when it was all over? It would look like a battlefield on which every soldier was injured.

So what I'm trying to do is take a little more civilized way of getting at the problem by saying we have agreed not to subsidize. We never have been very vigorous in enforcing those antisubsidy agreements, and we are not even going to enforce all of them. We are only going to enforce those where the subsidy does material injury to a U.S. manufacturer or U.S. producer.

For the life of me, I can't figure out why some of you in the trade area have gotten so upset about that. I'm a free trader, but I'm not a damn fool.

You know, I think that free trade is not subsidized trade. I don't know how anybody can think that free trade is subsidized trade.

You can respond if you want to. I apologize for having lectured to you.

Mr. FOX. Mr. Chairman, may I respond to that?

Chairman GIBBONS. Sure.

Mr. FOX. The National Association of Manufacturers has not taken a position on your bill because we have a divided membership.

Chairman GIBBONS. I noted that.

Mr. FOX. But I would like to respond to your question.

Chairman GIBBONS. All right.

Mr. FOX. I think that there has never been adequate enforcement in the GATT with respect to subsidies. There has been moderately active enforcement with respect to import quotas, certain import practices, but not with respect to subsidies.

The GATT was designed by Americans. It was designed really to be a market mechanism in which governments didn't play all that great a role. It was the market. What has actually happened is that governments now play a very important role in trade through industrial policy, which usually has an important subsidy component, as you know, through agricultural policy.

Chairman GIBBONS. Does the American businessman want that kind of policy for our country and for the world?

Mr. FOX. I will respond with respect to the nature of the problems as far as our association is concerned. Some of our members are concerned about covert retaliation by other governments in which the government is an important purchaser of their product. Others are concerned, not so much about that, but are concerned about unilateral action on the part of the United States that would tend to denigrate the rule of law. They would rather try to reform the GATT. And there are others who simply feel that if we got the exchange rate right, they could be competitive.

On the other side of our membership, are those who feel that industrial policy of other countries simply can't be overcome, particularly with the exchange rate that we have now and, of course, they are the ones who are inclined to support your bill.

Chairman GIBBONS. Yes.

Mr. FOX. My principal reason for asking to comment is that I think we have good reason to try to make the GATT work better.

Chairman GIBBONS. I certainly want to.

Mr. FOX. I know you do. We know your interest in this subject, and I think there are deficiencies in the GATT on subsidies and dumping, both of which are subject to codes that require serious consideration.

I'm going to make an informal comment now. It is not a recommendation, and it has no basis so far as our association is concerned, but actually the GATT encourages dumping and subsidies because the penalties are so weak.

In the United States, if you engage in unfair competitive practices, you get socked with triple damages. In world trade, all you do is get your duty raised to compensate for the amount of subsidy or the dumping price.

I think that penalty, which is traditional—it is in the GATT—I think that penalty is so weak that really it is an encouragement to the practices that are purported to be discouraged. I think that is a good subject for Ambassador Brock to take up with the GATT in a serious way.

I'm not aware that the subject has ever been seriously reviewed in the GATT. As you know, I've spent most of my life working on this subject. I don't think it has ever really been discussed in the GATT.

We started out at the Havana Charter with the concept that we were just going to make up the difference on the import side, and I don't think the penalties have ever seriously been reviewed.

As I said, that is an informal suggestion and doesn't represent the views of our association. We have never discussed it in our association.

Chairman GIBBONS. Well, of course in addition to that, we never could get the Treasury Department to decide cases. They just went on for years.

Mr. FOX. Well, I think that is a fair assessment. I think the Commerce Department is a little more active.

Chairman GIBBONS. They are more active, and I commend them for their greater activity.

Well, let's see, Mr. Schulze, you were the first one in.

Mr. SCHULZE. I'll be brief, Mr. Chairman.

First I'd like to thank the panel for their testimony.

If I can sum up, a great many of the people who have appeared before this subcommittee have stated that the problem with the trade deficit is because of the overvaluation of our currency; the overvaluation of our currency is due to the large deficits which create high interest rates, which attract capital from overseas. Therefore, the high imbalance or overvaluation of the dollar creates an impossible competitive atmosphere for our domestic producers.

We in Congress, over the past 4 years, took some of them away, but have put in some incentives for corporate America to be able to retain more of their earnings and to hopefully modernize and become more competitive.

I would say, in summing up the testimony we have had before us, that it hasn't worked. I would also say, after having recently spent a fair amount of time talking to my constituency, that when they see things like the automobile industry riding a crest at the moment and instead of reducing prices, which would have a ripple effect, again, in my own opinion, and would create more jobs, make more products available, and enable others to lower their prices, they have increased their prices and given executives large bonuses.

As one who has been very sympathetic to corporate America and has a constituency that has had sympathies laying in that direction, I'm rapidly changing, and I see my constituents are changing, but corporate America has brought it on themselves.

Does this mean we should now go to industrial policy? Not necessarily, but perhaps we ought to go back, and we can solve the budget dilemma and deficit dilemma by dramatically increasing the taxes on corporate America, and then we can subsidize exports and make you competitive that way.

I don't think anybody wants to go that way, but obviously you are not going to do it on your own.

We have tried to give you the wherewithal and the incentives to go ahead and modernize and be more efficient, and there are many in Washington and throughout the country who cannot understand why you cannot compete with a company in Germany or Italy who have to ship their products here, barring subsidization, but just compete on an equal basis, when you have got that tremendous transportation cost in your favor.

So I guess I hear what you say, but I'm getting less sympathetic all the time. If corporate America cannot compete—and I guess I'll dispute the 30 percent and say even with a 20-percent differential in the dollar—if we cannot, make use of our modern technology, computerization, robotization, then maybe we'd better start urging some of our constituents to go to Europe and look for jobs or go to Singapore or somewhere else. Maybe I should urge the businessmen to come in to me and help me get these contracts.

No; go overseas and start your business. Maybe we ought to give up, but we have given incentives, and it seems to me corporate America has not responded.

Maybe you want to dispute that.

Mr. Fox. Is that addressed to me, Mr. Schulze?

Mr. SCHULZE. Yes.

Mr. Fox. The figure, with respect to the German market, has risen in value 45 to 50 percent. Forty-five percent is probably the figure today, and I quote the report of the Council of Economic Advisers. I'm sure that American industry can be more competitive and is becoming more competitive, but you have got to be very, very good to overcome German competition that has a 45 percent price advantage plus the value-added tax.

Mr. SCHULZE. But it hasn't happened overnight, and we have been sitting fat, dumb, and happy when the mule was hit between the eyes with the 2 by 4 with the automobile industry some years ago. I don't think there is an astute businessman in the country who should not have gotten the message from that.

Mr. Fox. If you will permit me, Mr. Schulze, I'm going to let Mr. Hermann comment on the automobile industry. He knows that better than I. But I will say that with respect to the exchange rate, a 45-percent rise since 1981 is impossible to overcome when you are dealing with high quality, well manufactured, and properly distributed goods from Germany.

At this moment—and this is a personal opinion—the mark is more out of line than the yen.

No, it is simply impossible—and I guess I ought to quote the report by Data Resources which was published at the end of January in which they find the most proximate cause for the decline of the industrial sector in this country is due to high interest rates and capital formation and on the trade side to the exchange rate and lack of access to foreign markets.

Now, in order to be a competitive company in the world today in the manufacturing field, you have got to be a world-scale company.

Well, for 3 years now—that has been the period of this massive overvaluation of the dollar—American prices have been out of line by that amount, roughly speaking.

Now I think if we had a credible reason to say to American manufacturers that starting next January 1 the exchange rate will be more or less in line, they would make new investments. They would tool up their sales efforts, and I think——

Mr. SCHULZE. In other words, they want a guarantee. They want the government to say, "We are going to guarantee you a market." You are not going to get that.

Mr. Fox. No, no. If you will excuse me, I don't wish to argue, but you simply have to accept the situation that the exchange rate is supposed to reflect competitiveness, not create it.

What we now have is a situation in which the exchange rate is creating super competitiveness for Japan and Germany, and it is a period of recent duration when it is extreme, but it is a persisting one, according to Data Resources, since the mid 1960's.

Mr. SCHULZE. I know the grass always looks greener, Mr. Fox, but as one who came from the private sector and really yearns to get back to it, I would love to go into a business today and build small, extremely efficient plants close to the markets all around this country. We are still the largest market in the world.

Mr. Fox. Let me cite a figure from the Department of Commerce published report. According to the Department of Commerce, total exports fell by $33 billion in the last 2 years, leading to a loss of 1.3 million jobs, almost a fifth of all employment related to exports. The primary reason associated with that is the exchange rate.

Now, I agree that American firms have to compete; there is no alternative; and I'm not saying they are doing a 100-percent job, but I think from the information we have in our association, there have been tremendous cost savings, improved utilization of labor and productivity, and given a decent exchange rate, I think they can make it.

Mr. SCHULZE. Let me just interject there that I think the imbalance in the exchange rate within the next 12 months is going to be adjusted somewhat. Now I'm not going to say totally. That is my seat-of-the-pants chart.

Mr. Fox. Sir, I hope you are right.

Mr. SCHULZE. My own personal econometric model tells me that that's going to happen. In fact, I've said to people who are in international contracting I would be wrapping up all the contracts I could right now because——

Mr. Fox. I think our membership would sign that deal.

Mr. SCHULZE. You see, there are no guarantees, especially in our economy. That is why there are winners and losers. But corporate America has really gotten kind of fat, dumb, and happy, and it concerns me.

I have been sort of on a personal crusade over the last 6 years, going around the country saying your competition is not in Dallas or San Francisco or Des Moines, IA. It is in Hong Kong or Singapore or some small city in Italy. But nobody's listening, but they do come into my office when they are about to come out of business and say, "These guys are selling it cheaper than I can do it." But they have been taking the profits out and giving high wages when in the long run it has not been in the best interest of the company.

If they had talked to their employees and developed a relationship and said, "Look, boys, we are in this together. Here's what we're fighting against. Let's take this money and put it into modern equipment and expand our markets," I think we could have done a lot that we could not do.

Mr. Fox. I don't think NAM would yield to anyone in terms of its regard for the free market, and we don't advocate abandoning the free market in favor of industrial policy or subsidies or anything like that, but, sir, I think you underestimate the importance of the exchange rate.

So far as our membership is concerned, the two most important economic problems facing the country, both the subject of resolutions in February, are the size of the Federal budget deficit and the size of the trade deficit.

I sort of took the time on the automobile question, I'm sorry. I can't respond to that.

Mr. SCHULZE. But if we ameliorate those two problems, everything is going to be marvelous, isn't it?

Mr. FOX. What I said was, if we would ameliorate those problems, then I think American industry could be competitive.

I think it would be helpful if we had an Eximbank like other Eximbanks. It would be helpful if we would ease up on the Export Administration Act and didn't have our special brand of discrimination against the American exports to friendly countries as well as others. And I think it would be useful if we could make the GATT system work better so that the GATT would pay some attention, more than it does now, to subsidies and dumping as a factor.

I'm speaking of an international mechanism. I'm not saying that we should do things unilaterally.

Mr. SCHULZE. Let me ask you one more question. I'm taking too much time.

I foresee a gradually increasing possibility of a confrontation between our manufacturing base and the agricultural community in this country. More and more, I hear them saying, "Well, let them ship the steel in because they have to get hard currency to pay our bill." That frightens me. I don't want to see a confrontation along those lines. Do you have any concern on that?

Mr. FOX. Yes; I do. I agree with that very much. Although NAM does not represent agriculture as such, we represent a lot of agricultural processing companies, and I think if you will check the major farm organizations, you will find that the exchange rate is the No. 1 export problem that they now cite.

Mr. SCHULZE. Thank you, Mr. Chairman.

Chairman GIBBONS. Mr. Jenkins.

Mr. JENKINS. Thank you, Mr. Chairman.

Mr. Roberts, you make the statement, "If U.S. industry is to compete successfully in third country markets, it must be prepared to meet the competition of products and services from countries which provide government assistance to domestic producers. The alternative is to forego the opportunity to operate on a world scale."

How are you saying that American industry is to be prepared to meet that competition where there is obvious government assistance?

Mr. ROBERTS. It is a formidable challenge, I would say, sir. We can, of course, and should, continue to work within the GATT framework to attempt to enforce the subsidy and antidumping codes and otherwise to make use of those international conventions and agreement which set some rules of fair play in the international trade game.

Mr. JENKINS. It hasn't worked too well?

Mr. ROBERTS. It has not worked nearly as well as it should, and I think it is very fortunate that at the forthcoming London Economic Summit there will apparently be some initiative by the United States looking toward establishing a new round of talks regarding the GATT and changes which should be made in it, because the GATT has not successfully dealt, or is not even at this point set up to deal, with problems of preclusion of a foreign investment. It doesn't deal with services. It doesn't deal adequately with high technology problems, and so forth.

Mr. **Jenkins**. What do you do with Mr. Herman's people while we are waiting on that? How is he to meet the competition from countries that have subsidized industry by their governments? What words of encouragement can you give him?

Mr. **Roberts**. Well, perhaps Mr. Herman would like to speak to that first.

Mr. **Jenkins**. I think I know what he is going to say, but what do you advise?

Mr. **Roberts**. I cannot advise him that an easy path lies ahead, and he knows that as well as I.

My remark was really addressed to the difficulty which we see with a unilateral—that is to say, the United States effort to preclude additional imports because they are allegedly made under unfair conditions, made with excessive—in our view—government assistance.

Mr. **Jenkins**. You would not advocate the prohibition of those articles coming into the marketplace here?

Mr. **Roberts**. Well, only to say that even if we do prohibit them—and I doubt that we can accomplish much by doing that—but even if we did, that doesn't help us out in the rest of the world—that the United States barring of imports only protects our home market. It doesn't protect us in the rest of the world, and that, I'm simply saying, is a weakness in our leverage. We do not have all the power we would like to have.

We cannot, simply by closing our borders or laying a heavy tax on certain kinds of imports that we feel are unfairly made and produced—we cannot, by doing that, avoid the problem of competing in the rest of the world, because our laws do not extend beyond our borders.

If we are to get anything in this whole exercise, it has to be, we believe, through the GATT, and the GATT is an extremely slow moving organization with a number of major problems connected with rapid enforcement and connected with rules that really and truly deal with some of the subtler forms of subsidies.

So reform in the GATT subsidy code is a must, in our opinion.

Mr. **Jenkins**. Mexico doesn't even belong to GATT. What can we do about that?

Mr. **Roberts**. That is another extremely difficult problem.

Mr. **Jenkins**. This is giving great encouragement to Mr. Hermann.

Mr. **Roberts**. I know.

We have, I think, to shape the GATT a little more so that countries such as Mexico perceive it is in their interest to belong. At the moment, they see it is not that interesting to belong, but if the GATT is effective in dealing with unfair practices, which ultimately will affect Mexico like any other country, they may well decide to join.

The problem, I'm sure, is a lot more subtle than that and has to do with the strong Mexican ideology, which is very difficult to combat.

It is regrettable that more countries do not belong to the GATT. We must make an effort to reform the GATT and bring them in.

Mr. **Jenkins**. I think everyone is desirous to have as free and open a marketplace as possible, but today ours is probably the only real marketplace for a variety of reasons.

To a great degree we have the marketplace of today because of the world recession and other reasons, and it appears to me that we keep telling our domestic industry to increase its competitiveness, and to wait a little while longer.

We realize that you can't get into the Japanese market, that they have designed their marketplace so that they only purchase Japanese parts for whatever reason, that we as a country must retrain and reeducate all our people for high technology jobs when there are not enough high technology jobs now to take care of those people that we are concerned about.

Furthermore, we apparently are not going to put that kind of money in a program when we have huge fiscal deficits. That does not give much encouragement to domestic manufacturers who are really attempting to compete, and it appears to me that we are leaning over backward to protect the foreign exporter to the detriment of our own manufacturing concerns.

Mr. ROBERTS. Well, Mr. Jenkins, it is encouraging, I think, that the President of the United States is dealing directly with the head of the Japanese Government. It is encouraging that the U.S. Trade Representative is working a way, talking now about Japan, slowly but with some success, on issue after issue, the latest being beef and citrus.

It is indeed a very difficult task which we lay on our Government negotiators, which is to try and get other countries to reduce those protectionist barriers. The economic summit and these toughminded negotiations which go on between the United States and Japan ought to offer some consolation to U.S. industry because they do ultimately have the effect slowly but surely of opening up markets.

In addition to that, as I stated in my testimony, one other cause of the trade deficit which is rather outside our control and outside the control of the U.S. Congress or anybody else is the debt in the Third World, the massive debt in the Third World and the recession which still exists in many parts of the world.

I would draw that to Mr. Schulze's attention also as being a factor, which is to say that even if we had a well-adjusted exchange rate that was back to the levels of several years ago, there would still be major problems about competing abroad. One of them comes to the fact that the rest of the world is still in a recession and you can't sell much to people who have not got any money.

Mr. JENKINS. So you are recommending that we increase the appropriation for IMF and other financial institutions.

Mr. ROBERTS. Those are steps. I would not advocate a large or huge appropriation. This is the job of the other industrialized nations as well, but we certainly should do what our conscience tells us is right.

Not only that, but it is very much in our self-interest to support such institutions, because as has been said over and over before to this committee, the developing world purchases about 40 percent of all U.S. exports, so that is a good investment for us.

Mr. JENKINS. So there is a legitimate reason for us as a legislative branch to offer some degree of protection to the financial institutions through increased appropriations of IMF and others, but it is wrong to have any protectionism whatsoever for domestic manufacturers.

What we are doing is trying to increase the purchasing power of the Third World countries that are in deep difficulties, but some of those difficulties could be handled by the financial institutions that made those loans by restructuring the loans?

Mr. ROBERTS. They have a responsibility in this regard and we have a responsibility which is to keep our markets open to the developing world so they can sell their products here, which will enable them to get their own economies in order and buy our products. So it is very much of an interdependent two-way street.

Mr. JENKINS. It appears that they must have money to make their interest payments to keep out of default.

Financial institutions restructure the loans to keep from having a nonperforming asset on their financial statements. They could do a large part of it themselves, could they not, without letting Mr. Herman pay taxes to decrease the bank's problem?

Mr. ROBERTS. You mean they could just take a bath?

Mr. JENKINS. Certainly. He takes a bath every day when he makes a bad decision.

Mr. ROBERTS. If the U.S. banks taking a bath would solve the problems of Third World debt, it would deserve serious consideration but I am afraid it would not.

Their economies are in very serious trouble, of course, because they are burdened with loans and they have relied far too heavily on debt as a way of financing themselves, but even so they have a series of other problems connected with the fact that they are not sufficiently industrialized. They may have very backward economic policies and so forth, all of which have caused their economies to exist in a semirecession in many cases for years and years and years.

Mr. JENKINS. My time is up.

Thank you very much.

Chairman GIBBONS. Mr. Pease.

Mr. PEASE. Thank you, Mr. Chairman.

I will try to be brief. I guess I would like to ask our panelists a couple of questions.

If exchange rates come into a more realistic and acceptable range, if Europe and the rest of the world get out of the recession and are able to buy again, and if the LDC's get some kind of handle on their debt problem and are able to buy again, are we likely then to be able to compete effectively as Americans in the export market?

Mr. FOX. I think so.

Mr. PEASE. I understand and agree with your testimony about the primary causes of our trade imbalance. However, you have alluded to some other factors that at the margin influence our ability to compete overseas.

What about the shortrun profit orientation of American business? We were in Japan about a year ago and Japanese managers told us their jobs were to look after the competitiveness of their firms 12 or 13 years down the road, that some of the predecessors had taken care of them being competitive at that moment and their job was to look another decade down the road.

We have the impression for a variety of reasons there is a real emphasis on shortrun profit considerations in American business which has a deleterious impact on investment in new plant and equipment, research and development, and so on.

How serious a problem are we facing? Is this a legitimate criticism of our system?

Mr. Fox. Mr. Pease, I would say that obviously there is something to the point. The National Association of Manufacturers had a meeting yesterday in Canada with the Canadian Manufacturers Association. Several members of our board of directors were present and described the cost-cutting steps that they were taking and the steps that they were taking to increase their efficiency, and they were impressive statements by senior leaders of American manufacturers.

The Canadians were envious that they could not take steps as effectively in Canada for a variety of reasons that they set forth.

I don't think there is an easy way out of the problem. I would not describe anti-U.S. export policies of our Government as the margin.

I think they are significant. Nevertheless, I am convinced if we could have an exchange rate relationship that is in the ball park, the American industry by and large—and I am not just referring to the highest of the high tech—I think by and large, American industry could be competitive and would be competitive.

Mr. Pease. I saw Mr. Roberts shaking his head vigorously before. Would you like to comment on this matter?

Mr. Roberts. I would just note that the Conference Board did a survey of a large number of U.S. companies and asked their executives frankly, "Are you gentlemen just thinking of the next quarter's earnings or are you thinking long range?" And essentially they said, "We are thinking long range." They denied the allegation that has been made in the Harvard Business Review and by others that they only think about the next quarter's profits.

But let's face it: Survival is involved here too, and for many companies, if you can't get through the next year when you are in a difficult position, you are not going to have a 5-year plan to execute because you won't be there to execute it. So there is a great deal of attention focused on immediate competitive factors.

It is regrettable that this has to be so. Possibly there are fundamental changes that could be made in the U.S. system of supporting companies. By that I mean through loans and through equity that would encourage either banks or stockholders to stay in for the long pull.

These, I think, should be considered so that companies are not constantly confronted with the fact that if they don't make it through the next quarter, they ain't going to make it at all. That would lead, I think, to some more long-term strategic thinking.

But in the companies that are members of the National Foreign Trade Council, most of them have long range planning departments. They think in terms not of 5 years or 3 years but of 10 years. They try their best to look ahead and see what is going on in the international economic environment and how they can react to it successfully.

So that there is a mixture within each company, within departments of companies and within industry as a whole as to the extent to which time and effort can be devoted to long range plans. It obviously is in our interest to do so in this rapidly changing economic environment.

Mr. HERMANN. Mr. Pease, I would just like to comment if I may with regard to a competitive spirit and reinvestment in plant and equipment so far as our industry is concerned which is the automotive parts industry.

We have had a history of highly competitive business because of the fact that part of our business is supplying the car manufacturers with parts, which is a very competitive business.

Again, speaking on a personal note I could tell you that from the factories that I have seen throughout the world, that our industry would take a back seat to none so far as automation is concerned and reinvestment is concerned and the rest.

Again, just a matter of public knowledge, in the Wall Street Journal the other day, I believe, there was an article regarding the car manufacturers which we do not represent. However, it was interesting to note since we do supply them, their financial health is very important to the automotive parts industry in this country, and they said that Chrysler reduced their break-even point from 2.2 to 1.1 million cars; that Ford accomplished a 30 or 40 percent drop in their break-even point; and General Motors' efficiency was comparable to what Ford's experience is.

So I think that in a measure they are cognizant of their need to be more competitive in world markets. But again, just for the parts industry, I could assure you that we have done and will continue to do what has to be done to be competitive insofar as the manufacturing costs are concerned.

Mr. PEASE. Thank you—that is reassuring to me. I have been a little fearful that the whole business of our stock market and analysis of companies' positions encourage companies to show shortrun profits rather than to invest their money in longrun research and development.

Let me ask, in connection with one other question, what do we say or think about American-based multinational corporations which have operations in Mexico, Brazil, Spain, all over the world, even if the playing field were made more level? Would not a lot of those multinational corporations move their manufacturing operations or part of them overseas if there were a marginal advantage to doing so?

In other words, if you can get a 9.5-percent profit in the United States and 9.5-percent profit in France or Spain or Brazil, or wherever, wouldn't the tendency be for a multinational corporation to do that? In that case, the jobs are lost to the United States and the export potential is lost to the United States even though the other factors that we have been discussing this morning might have been taken care of?

Mr. ROBERTS. You raise a complex series of concerns. I would like to ask Mr. Fox if he would help me address a few of them too.

One is that I do not detect on the part of our members a desire at the drop of a hat or the drop of a percentage point to set up a factory in Mexico or here or there abroad. Decisions to move into foreign markets usually go like this. Most American companies would strongly prefer to be exporters rather than to go overseas to do the job if that could be done, but there are a variety of factors which may cause companies to establish plants abroad.

One is obviously access to raw materials or indeed they may be exploiting a foreign mine or drilling for oil in a foreign country, and the only way to do that is to go over there.

A second reason is there frequently are laws or practices which impede exporting. You have to go to that foreign market in order to do business there. The pharmaceutical industry is an often used example of that. You have to make the pills over there because the laws of those countries won't let it happen otherwise.

Now some of those laws we object to very strongly because they are simply protectionism in themselves. There are countries that insist that products be made there or they don't come in at all, and many of those laws are extremely arbitrary. And we, therefore, favor some work which is going to be done again at the London Economic Summit we hope which look toward relaxation of investment barriers.

A third factor is, of course, that local markets frequently require products which are adapted to local conditions which have to be made there, either using local raw materials or for a variety of other reasons made on the spot, it is the only way economically to serve that particular market.

We know that foreign investment by American companies does work very much to our advantage in nearly all cases in that it pulls exports. The figures vary, but at least 25 percent, and perhaps more, of all U.S. exports which are going forth to the world go to U.S. multinational companies. In short, they purchase from the United States so we don't lose that market.

In addition, such foreign investment leads to new markets and the kind of economy of scale which Mr. Fox testified to earlier, the gist of which is that in this competitive world today, the companies that are going to succeed for the future in large-scale products must operate on a world basis.

Mr. Fox. If I might add a word, of course, I agree. I think the Congress might want to satisfy itself. Generally speaking, in most years, General Electric Co. is the No. 1 exporter in the United States. My impression is that GE goes abroad very reluctantly if they can manufacture in the United States. They have done a terrific job in modernizing their diesel locomotive plant in Erie, PA. There are many examples. I just cite them because they are usually the largest exporter in the United States.

Other companies of a similar rank that prefer obviously to export rather than go abroad, Boeing, Ingersol Rand, a whole bunch of them, and I would suggest that when they locate abroad, especially under current conditions, they are motivated by economic considerations, including exchange rate.

I would have said in 1980 prior to this runup of the dollar, there was a trend toward disinvestment in foreign plants by American multinationals. They found American labor more reliable. They found that they had more control over the management of their firms than they did in many countries because in many countries they had to deal with nationally organized unions which were really political parties. They had to deal with a great deal of government intervention, and they really preferred the situation to increase investment in the United States.

That is an opinion. I think the facts will bear that out. Maybe the committee might want to undertake further investigation to satisfy itself on the point.

Mr. **Pease**. Well, thank you.

Again, I am reassured by those answers, although I do think that the committee ought to look more specifically at them.

I know a couple of companies that have plants in the United States and in Ireland or in Belgium, or whatever. I think what concerns me especially in the recessionary period, if they have a plant operating at half capacity in Ohio and a plant operating at half capacity in Ireland and they can make the product marginally cheaper in Ireland, would they not move the operation to Ireland and leave the workers in Ohio high and dry?

It is an economic decision, but it does create some problems for those of us here in the United States who are trying to look after our constituents.

Let me turn now to the Motor and Equipment Manufacturers Association. Mr. Hermann, I was interested in your very dramatic chart. It shows a great and impressive shift in the wrong direction in our trade with Mexico in part. What portion of that imbalance of that great increase in imports represents American companies out sourcing for GM, Chrysler, and others, going down to Mexico and making parts and bringing them back to the United States?

Mr. **Hermann**. Mr. Pease, I don't have any figures other than the overall figures to tell you, but I can relate a few instances to what has happened in Mexico. When the economy declined because of the oil crisis, the car manufacturers stopped making cars. So, for example, we supplied Chrysler with parts. They built 120,000 Chryslers in Mexico. They predicted they were going to build 150,000.

We manufacture one small product for them which we would export to Mexico, and it would be assembled in Mexico for Mexican production. They stopped all of that. They just made very few cars, and that had a dramatic effect on all of the parts suppliers who were involved in the supplying of parts.

You have GM, Ford, Chrysler, and American Motors, all four companies assemblying cars in Mexico. All four companies are supplied by American parts manufacturers. They brought that to a standstill practically, a dramatic effect.

Mr. **Pease**. Well, I raise this question because when we talk about competition from overseas, we normally think in terms of a German company or Japanese company being able to sell more autos or auto parts or machine tools, and so forth, in the United States.

I have a notion that the statistics don't really bear that out. That in many cases it is not German or Japanese companies which are having more success selling to the U.S. market; rather it is American companies which are going over to Mexico or Brazil out-sourcing their parts production and shipping them back in.

I see Mr. Fox is shaking his head. You disagree with that?

Mr. Fox. Well, there are data prepared by the Department of Commerce in the Bureau of Economic Analysis on imports and the origin of these imports and the proportion of those imports that come from American-owned companies abroad. They are readily available. By and large, they do not support the generalization you have made.

I am sure those data would be available if you request them from the Department of Commerce.

Mr. PEASE. I appreciate that.

Finally, I would like to make a quick comment because I have far overrun my time. I guess I can't avoid the temptation to ask Mr. Fox to comment on Mr. Roberts' testimony on page 3 in which he says that the decline in our competitiveness is due partially to the exchange rates but also to the overall quality and specifications and such related considerations of U.S. products.

He goes on to say that there is abundant evidence that some of the American products are of mediocre quality, are poorly adaptive to use abroad and so forth. Do you accept that indictment?

Mr. Fox. No, I don't. I think Mr. Roberts is describing a condition which has sort of been built up by the media. It might have had a higher degree of relevance five or 10 years ago than it has now. I believe quite sincerely, as I have stated, that there has been a tremendous improvement in the U.S. manufacturing industry from the standpoint of quality, cost, and all the elements that enter into competitiveness.

I wouldn't argue further with my colleague on my right here, but I think his observation is overdrawn.

Mr. PEASE. Mr. Roberts, did Mr. Fox win you over?

Mr. ROBERTS. Well, I think we have largely the same bosses here, to wit, many members of the NAM are also members of the Council.

I think it is really a matter of emphasis and I was not attempting to draw a picture of American inefficiency or anything like that. There simply are cases, and we must not overlook them, where American products have had an extremely tough time both in this country and abroad in gaining acceptance.

There have been a number of studies. One to mention would be one by the Harvard Business Review regarding a single product, room air conditioners, and a rather elaborate study of this rather simple device, the technology of which is fully known to all. And American air conditioners by and large, even the best of them, fell short of Japanese and some other foreign-made air conditioners in terms of repairs, in terms of servicing and so forth.

So there are documented instances in which our quality has fallen down.

As one member of the committee mentioned, before we have had to some extent in this country a fat, dumb and happy attitude, but that is changing. So Mr. Fox and I do not disagree. I think we would only disagree slightly about the degree of improvement and how soon we can do it.

But I think we would both agree that to the extent that U.S. industry has not been able to adapt as quickly as other countries have in respect to particular products, we must get on with it as quickly as possible. And what we would seek here would be very simply an environment in which U.S. industry can pull its socks up as fast as possible and get on with it for the sake of survival and for the sake of economic leadership.

Mr. PEASE. Thank you.

Thank you, Mr. Chairman.

Chairman GIBBONS. Mr. Frenzel.

Mr. FRENZEL. Thank you, Mr. Chairman.

Gentlemen, I am grateful for your testimony and glad you could come here today. I think what you told us has been very helpful.

Mr. Hermann, you indicate at the bottom of page 6, and the chairman asked you about this a little bit too, about Japanese parts companies coming to the United States, and you indicated that was a cause for concern. You don't think we should keep them out of the United States?

Mr. HERMANN. No; I don't think we should keep them out of the United States. I just think that if we are going to have an opportunity that everything should equal. We should have free and fair trade.

As I explained in my discourse, Mr. Frenzel, we are cut out of the Japanese network of being able to supply their dealers, which is very significant. That is ability in the marketplace. Today 30 percent of the cars sold in the United States are Japanese manufactured. So what is happening dramatically affects our industry and your constituency by the fact that they are supplying these parts from Japan.

If they bring their factories here and people supply the car manufacturers directly, obviously it is their privilege to do so. However, we should have a free and open marketplace.

Mr. FRENZEL. I don't think anybody could disagree with you. I can recall, however, being in Japan and asking the Japanese, following the leadership of Douglas Frasier, to make more cars and to make more parts in the United States. And now that they are doing that, it is hard to complain.

We do like the investment. It would be nice if Americans would do it, but it is a little hard to complain if others come over and invest here.

Mr. HERMANN. I think we have to segregate and not confuse the car manufacturer with the car parts supplier. We represent the car parts supplier, and what we have stated is the fact that they are going to come over here, they are ignoring the industry that is presently in place for no reason. That is No. 1.

Number two is that they cut us out of their channels of distribution, so we are unable to go ahead and tool those parts just for replacement because there is no place to sell them. They control their own channels, and it makes it very difficult to sustain our own industry.

Mr. FRENZEL. Is that an unfair practice? Is it something that American companies never do?

Mr. HERMANN. The American companies, the automobile companies, do not prohibit outsiders from selling in their channels and distribution, no, sir.

Mr. FRENZEL. You mean if you want to sell, for instance, to a new Nissan plant in Tennessee, you are forbidden from bidding on it?

Mr. **Hermann**. They are very polite; they ask you to come in. We just had that experience, and we went in and we did quote them and they decided that they would prefer to stick with their traditional Japanese supplier. We just had a very personal experience on that.

Mr. **Frenzel**. But you believe that this is an unfair and uneconomic decision on their part?

Mr. **Hermann**. There is no question about the fact that it was uneconomic because we know we were competitive. We know we are next door to them. They have to bring the parts over from Japan.

However, there is a very close tie-in between the parts manufacturers in Japan with the assemblers of those components. It is all one family. It is very difficult to break in today.

Mr. **Frenzel**. Thank you very much.

Mr. Fox and Mr. Roberts, I appreciate your testimony. I was biting my lip when you were engaged in the discussion with the chairman about his bill. It is almost to painful for me to bring up at this point, but I must say that I take your points well and believe that as you look at the GATT rules and the GATT precedents, it is pretty hard to see how unilateral definition of subsidy is going to do anything but cause our trading partners to declare their own unilateral descriptions of subsidies.

I guess we know what we would do for agriculture and chemicals and forest products and literally everything that America grows or makes. So I feel that you are on the right track there.

Larry, when you were talking about GATT and the fact that there are no penalties, as you know, the United States has worked, I think with extreme diligence, particularly in November 1982, at the Ministerial to try to get the contracting parties to agree to some reasonable settlement procedures that had nothing to do with penalties and getting people to agree to do what the panels and what the contracting parties decided was reasonable under the circumstances.

We were not able to do that. Of course, we have been negotiating safeguards forever and ever and subsidies. We have tried to interject services and investments and agriculture in the scheme of things. We were stonewalled by our friends at the EC, although most of the rest of the world supported us.

We know that the taxes, which I think was part of your testimony, is being a competitive factor and I don't know if you mentioned credit, but, of course, that is outside the GATT as well as taxes.

What are we going to do under those circumstances? The United States designed the GATT and we are at a point now where most of the conditions and factors that drive trade are not controlled by the GATT. Where do we go? Is it time to totally regroup?

Mr. **Fox**. Well, Mr. Frenzel, it is a very thoughtful question, and I know that it is one that Mr. Gibbons has given a lot of thought to. The GATT really is deficient. It was designed in the 1940's in a world in which subsidies and industrial policy was not a very important subject. Subsidies in agriculture was understood perhaps, but not in industry. It is a different world, and the GATT is out of date in that regard.

Now, as I indicated, NAM at this time is not testifying for or against Mr. Gibbons' bill, but we would say he is trying to address a serious problem, and if the GATT refuses to consider that serious problem, well, then, countries, and I am not suggesting the United States alone, but countries will have to address their own interests.

Now, maybe Mr. Gibbons' bill will get the attention of the GATT even if it doesn't pass, which I am not predicting necessarily. But obviously the GATT prefers the members of the GATT, who are not disadvantaged by subsidies, they are sort of cozy in their present situation, and they prefer not to deal with these problems.

I think that the antisubsidy code and the dumping code were valiant efforts, and they haven't succeeded very well. And I think the problem has grown worse since those codes were adopted in the GATT, and it requires to be addressed.

Now, I think Ambassador Brock, as you indicate, did his best to bring this subject up and related subjects which turn on the subject of government intervention and direction of the economy, and he hasn't succeeded yet. I don't think we want to give up on the GATT, but certainly the United States being the largest trading entity in the world is entitled to have a system that is reasonably responsive to the nature of our economy, which is a free market economy and not a government-directed economy.

And if the GATT, through its members, can't address itself to these issues which are raised by the United States, well then, I say we have to consider what the alternatives are then.

I feel at this time it has been too easy for the GATT. The GATT doesn't exist. It is only the members who exist. It has been too easy for the European community to stonewall us, and they have. Japan has its own techniques, not really through the GATT. Japan delays things until the problem becomes impossible to solve, or they are so supercompetitive, it is not relevant. Japan doesn't really use the GATT. Japan has never complained in the GATT.

We have different problems with Europe and with Japan, but I think it is premature to give up on the GATT, and I think it is important to address the subject of the degree of government intervention and government ownership of industry which now prevails and determines, between the two of them, a very large part of trade flows.

Mr. FRENZEL. I agree with you. I think the GATT is like our tax code or maybe even like our Republic itself, perhaps not terribly effective or efficient, but it is all we have got.

Mr. Roberts, did you want to comment?

Mr. ROBERTS. No; I believe I agree with everything that Mr. Fox said.

Mr. FRENZEL. I just want to conclude, Mr. Chairman, by saying that one of the reasons that I have been working on Chairman Gibbons' bill with him and why I was an original sponsor was that I think these problems do have to be called to the world's attention, and perhaps using the two-by-four technique. I am sorry that it has to be that way because I think sometimes you get no effect from these and sometimes you get a little more effect than you would like to get overall.

But certainly I think the chairman has done an extraordinary service in highlighting what our legitimate complaints of American producers and American exporters are about the situation.

You are correct. Our principal trading competitors, that is the EC and the Japanese, can manage their problems in bureaucratic fashion. We are stuck with a transparent system of law here in which we can only move exactly as specified. We do not have the flexibility that our partners have.

Of course, that is one of the reasons that some of us are reluctant to change the laws because once changed, they are going to still be lacking in flexibility, and we cannot offer incentives and react to our trading partners' initiatives.

Well, I think it has been a very instructive morning for me, and I thank all of you.

I yield my time.

Chairman GIBBONS. Thank you very much.

Mr. ROBERTS. Thank you.

Chairman GIBBONS. To the next set of witnesses I want to say I apologize to you for not scheduling you the other afternoon, but I think this is a better time, anyway.

The panel from the American Federation of Labor, the AFL-CIO, Rudy Oswald, and the International Union of United Automobile, Aerospace and Agricultural Implement Workers of America, Mr. Lee Price.

Mr. FRENZEL. Mr. Chairman, I regret that we now have a reconciliation bill on the floor and I am going to have to depart. I apologize.

Chairman GIBBONS. Well, we will miss you, sir. Get it reconciled, though.

Mr. Oswald and Mr. Price, I apologize to you again. We had to move your witness time around, and I hope it did not inconvenience you.

Mr. Oswald, why don't you proceed as you wish.

STATEMENT OF RUDY OSWALD, DIRECTOR, DEPARTMENT OF ECONOMIC RESEARCH, AMERICAN FEDERATION OF LABOR & CONGRESS OF INDUSTRIAL ORGANIZATIONS

Mr. OSWALD. Mr. Chairman, we appreciate this opportunity to present the views of the AFL-CIO on what we think is a very major issue in terms of the questions facing the country and as they interrelate with other domestic economic issues that you talked about. I would like to highlight part of my official testimony and talk about the elements that affect the great deficit.

I think part of the problem comes with the ideological approach of talking only about free trade, whereas that is not the general practice in the world today. The questions of national interests tend to be dismissed or relegated to a lower status, and success is measured not by the health of the domestic economy but by one's adherence to a theoretical construct.

The free market really does not exist, and we somehow forget about that, and we just heard that at the very end of your last testimony.

It should be clear by now that our trading partners have a different perception of what free trade is about. Other countries see trade as a means to the larger goal, balanced economic development and employment. While it is true that tariffs have been lowered through the successive rounds of monthly unilateral trade negotiations, there is a whole new array of nontariff barriers such as stringent inspection requirements, exchange rate manipulation, discriminatory standards by national policies, export subsidies, industrial targeting programs, and trade arrangements such as performance requirements, coproduction, offset and barter agreements. All of these different methods have been developed in recent years to take care of national interests.

Continued attempts by the United States to reduce the use of these measures have just not been successful, and our own market remains wide open to an ever-increasing volume of imports.

This trade policy framework, together with the ill-conceived monetary and fiscal policies of the administration, has contributed significantly to the massive trade deficits the United States faces today.

You are well familiar with the numbers, the $70 billion this year and last year. The projections were $115 billion. This year the figures that have been compiled by Data Resources, Inc. that the loss of 2½ billion jobs as a result of these deficits and the direct impact thus on workers in the United States today.

The impact has been that there has been a complete shift in recent years so that in 1983 the surpluses were only in agricultural products, and chemicals and manufactured products has collapsed completely. In 1980 we still had a slight surplus of manufactured goods by $12.5 billion. In 1983 in manufactured products we had a $37 billion deficit. So far the first 2 months of this year the manufacturing trade deficit has been running close to $7 billion a month. If that continues, we will be running nearly $90 billion by the end of the year.

You are familiar, of course, with the big deficits with Japan, the $22 billion, $14 billion with Canada, and what has been surpluses with the economic community are now deficits of $1.5 billion.

But we feel that the official numbers dramatically understate the impact on U.S. employment. The published data measures trade flows in dollars rather than physical quantities, and this invariably understates the job losses caused by imports.

Because of low labor costs in many of the countries where U.S. imports originate, $1 of imports displaces more than $1 of U.S production of the same item. Accordingly, the use of unadjusted dollar values to measure the employment effects of imports significantly understates the job losses in the United States.

A factor which has made dollar-denominated measures of trade flows even less reliable is the sharp rise in the foreign exchange value of the dollar. The appreciation of the U.S. dollar raises the foreign price of U.S. exports and cheapens the U.S. price of import goods. An appreciating dollar increases the employment impact per billion dollars of U.S. imports. From July 1980 to February 1984, the exchange value of the U.S. dollar increased by 56 percent relative to the currencies of other major developed countries. Moreover, sizable devaluations in many developing countries further increased the value of the dollar on foreign exchange markets, causing even greater employment effects per billion dollars of imports.

There were questions before about what that means and is it a sudden change. It is a sudden change to have a 56-percent change in a 3½-year period, and people sometimes say, well, the workers should adjust. Well, workers can't be expected to take a 56-percent wage cut because of the general policies that have affected the value of the dollar are the major factors that make the change in competitiveness since 1980. In the whole 1970's, U.S. unit labor costs increased less than that of other major industrialized countries, and the result is that you can't really adjust for that sudden basic, massive change in the overvaluation of the dollar through taking adjustments in wage rates.

We have addressed in our policy statements recommendations to deal with some of the basic fiscal and monetary policies which we think are major factors affecting the exchange rates, and we believe that the action of the Ways and Means Committee in terms of trying to address the budget deficit are major steps in trying to alleviate part of that problem.

The other elements that we believe need to be done is to look at overall trade impacts in terms of both fair and unfair trade practices, that there is no one, single element that will take care of all the trade problems but that first and foremost U.S. trade law must be structured to reflect the international trading realities. It is time to recognize that the principal approach to trade problems taken by the U.S. Government encouraging other countries to stop what are considered to be objectionable practices has changed. While negotiations take place, injury to the U.S. economy continues.

The recent agreement with Japan to change beef and citrus quotas are important changes, but a change of $125 million in trade with Japan on agricultural products will not take care of a $122 billion deficit on manufactured goods.

To help accomplish this policy reorientation, legislation is urgently needed to tighten and streamline the laws designed to relieve industries and workers injured by imports.

We believe that your bill is one small step in that regard. We would like to see it even stronger than it is, and we would like to see some of the extraneous elements not be added to it.

I am going to just touch a little bit about the areas of fair trade and injury.

The AFL-CIO believes that the help promised to injured industries for 20 years has not become a reality. The safety valve promised to those who are affected by tariff-cutting and import surges, the so-called escape clause, now section 201 of the Trade Act of 1974, has never been effective. Petitions under section 201 require expensive and extensive documentation. The criteria used by the International Trade Commission [ITC] in making determinations are so vague that findings of injury seldom result. In addition, even if the ITC finds injury on the facts and recommends that section 201 be invoked as intended by law, the President frequently decides not to implement the action.

The escape clause provisions of the Trade Act should be revised to allow quick relief from trade injury. When a U.S. producer loses sales to foreign producers and reduces his production and work force accordingly, he knows only that trade elements have injured his business operation, and his workers note the injury in the resulting layoffs. At this point, the injured parties don't know if the injury was caused by so-called unfair trade practices, by fair trade practices, by the rising value of the dollar, by foreign currency devaluation, or one or a combination of these causes. All they know is that the injury is trade related. Such injured parties should be able to receive temporary relief from the injury, and should receive help from the U.S. Government to make the appropriate case under the various provisions of the Trade Act that deal with specific relief measures for certain unfair and injurious trade practices. Many aspects of foreign government subsidy programs and dumping activities are more readily ascertainable by U.S. governmental agencies than by private U.S. parties injured by trade.

For this purpose, the statutory improvements should accomplish three major objectives: One, to assure that the ITC evaluates more quickly and accurately the impact of imports on an industry and its workers through more specific critiera; two, to fashion a specific remedy to alleviate temporarily the adverse effect of such imports; and three, to assure that the President not overturn the determinations of the International Trade Commission except with the explicit agreement of Congress.

For unfair trade practices, many of the same problems exist: relief is too little, too late, or not at all. Even for those with access to the financial resources and expertise to seek relief, the time-consuming procedures do not accomplish the intended result. These unfair trade practices procedures also need an overhaul.

Another important need is clarifying and strengthening 301 authority and procedures to identify and eliminate foreign unjustifiable or unreasonable trade policies or acts.

We believe there are a number of actions that Congress must take to deal with these specific elements. We dealt with domestic content in the House in terms of automobiles. We believe there are specific problems in the steel industry, garment, texile, and footwear, the maritime industry, electronics industries that need specific approaches to address them.

I would like to say just a few things on the overvalued dollar. We believe that in addition to the tax policies and budget policies we believe are essential to try and address the domestic economy as it affects the impact on the overvalued dollar that there should be attention to the specific provisions currently involved that allow the administration to do more to deal with the current exchange rate and balance.

First the United States, we believe, should pursue a policy of market intervention both unilaterally and in conjunction with other countries. We believe that the Reagan administration's inaction in this area has worsened the problem in terms of the overvalued dollar and has been an abdication of their responsibility in this area.

Second, attention should be focused on the administration's refusal to invoke section 122 of the Trade Act of 1974 which requires the President to impose a surcharge, quotas, or combination of both whenever fundamental international exchange rate problems or balance-of-payments problems dictate.

We believe that with the deficit approaching $150 million and with the increase in the last few years in the value of the dollar, that these elements exist and there should be at least the action of the President to consult with the Congress in terms of actions in this regard and that actions should be taken.

The problems, we think, also, would be addressed with a bitter emphasis on industrial policy in the United States to try to assure that there is emphasis on dealing with the particular problems of industries to meet both domestic balance and overall international competition.

Mr. Chairman, the AFL-CIO believes that adoption of these measures, trade law reform, restructuring of monetary and fiscal policy, as it affected the overvalued dollar, active intervention in the international financial markets and the enactment of industrial policy will result in achieving the basic goals of our economy, full employment and balanced economic growth.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF RUDY OSWALD, DIRECTOR, DEPARTMENT OF ECONOMIC RESEARCH, AMERICAN FEDERATION OF LABOR & CONGRESS OF INDUSTRIAL ORGANIZATIONS

Mr. Chairman and members of the Committee, I appreciate this opportunity to discuss with you the views of the AFL-CIO on the serious problem of the large and rapidly growing U.S. trade deficit. The sharp deterioration of the international economic position of the U.S. in recent years has had a profound and negative impact on scores of domestic industries and millions of American workers. Your recognition of the seriousness of this problem, as evidenced by these hearings, is particularly welcome and stands in sharp contrast to what can only be viewed as studied indifference on the part of the Administration.

The unwillingness of the Administration to take steps to arrest the decline of the U.S. position was outlined in the most recent Economic Report of the President. While noting the record U.S. trade deficits, President Reagan merely reiterates his belief in free trade, and rejects governmental action, in the apparent hope that through reliance on market forces, the problem will correct itself at some point in the future. He states in part:

"Despite these problems, I remain committed to the principle of free trade as the best way to bring the benefits of competition to American consumers and businesses. It would be totally inappropriate to respond by erecting trade barriers or by using taxpayers' dollars to subsidize exports. Instead, we must work with the other nations of the world to reduce the export subsidies and import barriers that currently hurt U.S. farmers, businesses, and workers.

"I am also firmly opposed to any attempt to depress the dollar's exchange value by intervention in international currency markets. Pure exchange market intervention cannot offset the fundamental factors that determine the dollar's value . . . The dollar must therefore be allowed to seek its natural value without exchange market intervention."

The tragedy of this approach is that the U.S. is frequently left defenseless in the international arena. By emphasizing, even rhetorically, the "value" of free trade, questions of national interest tend to be dismissed, or at least relegated to a lower status, and success is measured not by the health of the domestic economy, but by one's adherence to a theoretical construct. That the "free market" really doesn't exist is somehow forgotten.

It should be clear by now that our trading partners have a different conception of what "free trade" is all about. Other countries see trade as a means to the larger goal of balanced economic development and employment. While it is true that tariffs have been lowered through successive rounds of multilateral trade negotiations, a new array of non-tariff barriers such as quotas, stringent inspection requirements, exchange rate manipulation, discriminatory standards, buy national policies, export subsidies, industrial targeting programs, and trade arrangements such as performance requirements, co-production, offset and barter agreements have developed.

Continued attempts by the U.S. to reduce the use of these measures have just not been successful, and our own market remains wide open to an ever increasing volume of imports.

This trade policy framework, together with the ill-conceived monetary and fiscal policies of the Administration, has contributed significantly to the massive trade deficits the U.S. faces today.

The dimensions of this problem are startling. The U.S. merchandise trade deficit for 1983 reached a record $69.4 billion, 63 percent greater than the previous record of $42.7 billion set the year before. The current Administration predicts this economic decline will continue in 1984 with the deficit reaching $115 billion. This deterioration in the trade position of the U.S. is estimated by Data Resources, Inc. to be responsible for the loss of more than two and one-half million jobs, three-quarters of which are in the manufacturing sector.

While these figures are chilling in and of themselves, a look at the composition of the trade deficit paints an even darker picture. In 1983, the United States recorded surpluses in only two merchandise trade sectors -- agriculture products and chemicals. America's trade position in manufactured products collapsed. The U.S. has basically become an exporter of raw materials and commodities, and an importer of finished goods. In fuel trade, a sector which has traditionally contributed a large part of our merchandise trade deficit, the U.S. position has been improving over the last 3 years. In 1980, the United States registered a deficit of $78 billion for this sector. In 1983, this deficit had been reduced to $51 billion, a drop of 35 percent. While exports rose moderately, imports were significantly reduced.

Between 1980 and 1983, U.S. manufacturing exports had fallen 8 percent, while manufactured imports had increased 30 percent. In 1980, the U.S. enjoyed a surplus of $12.5 billion in this sector. By 1983, this surplus had vanished and the U.S. recorded a deficit in manufacturing trade in excess of $38 billion. So far in 1984, the U.S. has been running a manufacturing trade deficit of close to $7 billion per month.

Should this pattern continue as expected, the manufacturing deficit will reach $84 billion in 1984. This represents a decline of $96 billion in manufactured trade balance since 1980.

All manufacturing sectors have contributed to this dramatic turnaround in the U.S. position. From 1980 to 1983, the U.S. surplus in the chemical seqtor fell 28 percent. Exports dropped 5 percent and imports rose 25 percent. For manufactured goods classified chiefly by material (tires, paper, textile fabric, iron and steel, non-ferrous metal), the U.S. deficit increased by 85 percent to $21.9 billion. In the machinery and transport equipment sector, the U.S. position totally reversed itself going from a $21.2 billion surplus in 1980 to a deficit of $6.4 billion in 1983. Exports fell by 2.4 percent, while imports increased by 40 percent. For miscellaneous manufactured articles, the U.S. deficit more than doubled from $8.7 billion in 1980 to $18.4 billion in 1983. Exports dropped 6.7 percent and imports rose 34.3 percent. While it is clear that U.S. exports have declined across the board, the tremendous increases in imports bear primary responsiblity for the huge and growing deficits.

Examination of U.S. trade on a bilateral basis paints an equally dismal picture. In 1983, the United States experienced a $14.3 billion deficit with Canada; a $1.5 billion deficit with the European Economic Community; a $1.7 billion deficit with South Korea; a $7.4 billion deficit with Taiwan; an $8 billion deficit with Mexico, and a record $21.9 billion deficit with Japan.

As dramatic as these numbers are, they may very well understate the impact on U.S. employment.

The most fundamental problem is that published data measures trade flows in dollars, rather than physical quantities. This invariably understates the job losses caused by imports. Because of low labor costs in many of the countries where U.S. imports originate, a dollar of imports displaces more than one dollar of U.S. production of the same item. Accordingly, the use of unadjusted dollar values to measure the employment effects of imports significantly understates the job losses in the U.S.

A factor which has made dollar-denominated measures of trade flows even less reliable is the sharp rise in the foreign exchange value of the dollar. The appreciation of the U.S. dollar raises the foreign price of U.S. exports and cheapens the U.S. price of import goods. An appreciating dollar increases the employment impact per billion dollars of U.S. imports. From July 1980 to February 1984, the exchange value of the U.S. dollar increased by 56 percent relative to the currencies of other major developed countries. Moreover, sizable devaluations in many developing countries further increased the value of the dollar on foreign exchange markets, causing even greater employment effects per billion dollars of imports.

This massive increase in the dollars' exchange value has been a significant contributor to the collapse of the trade position of the United States. The appreciation is no different than a 56 percent tax on exports, and a 56 percent advantage for importers. That the dollar is overvalued is now almost universally acknowledged, even by some within the Administration. It is clear that this currency misalignment is placing severe costs on American industry and workers, and makes discussions on the need to increase competitiveness almost irrelevant. Should workers in export industries be forced to take a 56 percent paycut in order to restore their products' international competitiveness? I think not. The problem is not with American workers or U.S. industry, but with the policies of their government.

A major, if not principle, cause of the overvaluation of the dollar is the irresponsible fiscal and monetary policies of the Reagan Administration. Huge tax giveaways and unfinanced increases in defense spending has led to the huge budget deficits facing America today. These budget deficits, together with the tight money, high interest rate policies of the Federal Reserve Board, have kept U.S. interest rates high, encouraging massive capital inflows to the U.S. and, therefore, keeping the dollar artifically strong. These same capital inflows have to some degree slowed the capital exporting countries' economic growth by reducing their own pool of investment funds. Their slower growth rates have reduced their ability to purchase U.S. goods.

Similarly, high interest rates in the U.S. have significantly increased the magnitude of the debt crisis facing many developing countries. The higher debt service costs reduce their ability to buy U.S. goods and increases their need to acquire dollars through exports to the U.S.

Another aspect of this fiscal and monetary tragedy is that as U.S. firms find themselves being priced out of the international market due to the overvalued dollar, they may view relocation overseas as a viable alternative. Given the relative openness of the American market to foreign goods, further U.S. employment losses could occur.

Given these trade and economic policies, it is little wonder that the U.S. is facing a trade crisis.

The AFL-CIO believes that the goal of U.S. trade policy must be the attainment of a fair trading environment that allows this nation to remain an advanced and diversified economy, while promoting full employment and rising living standards in the United States and other countries of the world.

"Fair trade" means that the interests of the U.S. must receive greater emphasis in both the domestic and international initiatives of U.S. international trade and investment policy.

The United States must retain its manufacturing, agricultural, and maritime industries. The nation's foreign trade policy and its domestic economic policies must promote -- not undermine -- this goal. The trade problems facing the country are immense, and there is no one single action that will alleviate that problem. Rather the government must undertake a variety of specific actions to deal with the trade crisis.

First and foremost, U.S. trade law must be strengthened to reflect international trading realities. It is time to recognize that the principle approach to trade problems taken by the U.S. government -- encouraging other countries to stop what are considered to be objectional practices -- has failed. While negotiations take place, injury to the U.S. economy continues. The U.S. government must also develop a clearer idea of what interests it serves in implementing trade policy. Just last week, Ambassador Brock, in a speech before the National Press Club, said that Japan was risking its entire trading relationship with the U.S. by refusing to adequately relax its quota on U.S. beef exports. He stated the issue "has taken on a symbolic quality way beyond its substance." This is exactly what is wrong with the U.S. approach. In

1983, the U.S. had a large surplus in agricultural trade with Japan, quotas or not. The overall trade balance with Japan however was in deficit by almost $22 billion due to the tremendous imbalance in manufactured goods. That is the trade problem with Japan, not beef. Attention should be directed at substantive problems, not symbolic issues.

To help accomplish this policy reorientation, legislation is urgently needed to tighten and streamline the laws designed to relieve industries and workers injured by imports.

It is clear that the so-called "fair" and "unfair" trade remedy statutes need improvements. Both "fair" trade laws designed to alleviate trade-induced injury and "unfair" trade laws designed to counteract dumping and subsidies should have better procedures and more effective remedies.

The AFL-CIO believes that the help promised to injured industries for 20 years has not become a reality. The safety valve promised to those who are affected by tariff-cutting and import surges, the so-called "escape clause," now Section 201 of the Trade Act of 1974, has never been effective. Petitions under Section 201 require expensive and extensive documentation. The criteria used by the International Trade Commission (ITC) in making determinations are so vague that findings of injury seldom result. In addition, even if the ITC finds injury on the facts and recommends that Section 201 be invoked as intended by law, the President frequently decides not to implement the action.

The escape clause provisions of the Trade Act should be revised to allow quick relief from trade injury. When a U.S. producer loses sales to foreign producers and reduces his production and workforce accordingly, he knows only that trade elements have injured his business operation, and his workers note the injury in the resulting layoffs. At this point, the injured parties don't know if the injury was caused by so-called "unfair" trade practices, by "fair" trade practices, by the rising value of the dollar, by foreign currency devaluation, or one or a combination of these causes.

All they know is that the injury is trade related. Such injured parties should be able to receive temporary relief from the injury, and should receive help from the U.S. government to make the appropriate case under the various provisions of the Trade Act that deal with specific relief measures for certain "unfair" and "injurous" trade practices. Many aspects of foreign government subsidy programs and dumping activities are more readily ascertainable by U.S. governmental agencies than by private U.S. parties injured by trade.

For this purpose, the statutory improvements should accomplish three major objectives: (1) To assure that the ITC evaluates more quickly and accurately the impact of imports on an industry and its workers through more specific criteria; (2) To fashion a specific remedy to alleviate temporarily the adverse effect of such imports; and (3) To assure that the President not overturn the determinations of the International Trade Commission except with the explicit agreement of Congress.

For "unfair trade practices," many of the same problems exist: Relief is too little, too late, or not at all. Even for those with access to the financial resources and expertise to seek relief, the time-consuming procedures do not accomplish the intended result. These unfair trade practices procedures also need an overhaul.

Another important need is clarifying and strengthening 301 authority and procedures to identify and eliminate foreign unjustifiable or unreasonable trade policies or acts.

The response to foreign unfair trade practices under Section 301 has proven futile in most cases. The Trade Act of 1979 supposedly authorizes the President to act when another nation's "act, policy or practice . . . is inconsistent with trade agreements" or unjustifiably "burdens or restricts U.S. commerce." In short, when the other nations have unfair practices that affect U.S. exports, 301 is supposed to be a meaningful remedy.

But the detailed, lengthy procedural requirements, the refusal of the U.S. government to act even when the requirements are met, and the failure of the General Agreement on Tariffs and Trade (GATT) process to recognize U.S. rights generally makes 301 as presently structured, ineffective to defend U.S. rights.

In addition, to these proposals to help all industries hard hit by imports, the AFL-CIO believes that legislation should be enacted to deal with the problems of specific industries:

- Domestic content laws to help assure that the United States remains a producer of automobiles.
- Steel import quotas provided that the steel industry undertakes modernization actions.
- Action to reduce the job-destroying influx of garments, textiles, and footwear now inundating U.S. industry.
- Legislation to revive the U.S. maritime industry to substantially increase the portion of cargo carried in U.S. flagships, and to assure a strong U.S. shipbuilding base, thereby enhancing the national security.
- Policies to maintain and re-establish domestic electronic and television industries.

To address the problem of the overvalued dollar, and indeed the future health of the American economy as a whole, a fundamental restructuring of monetary and fiscal policy is essential. The AFL-CIO has appeared before Congress many times to recommend policies that would help restore fairness and growth to the U.S. economy.

It is clear that President Reagan's supply-side, trickle-down experiment has failed. The huge budget deficits, $195 billion in 1983 alone created by these misguided policies have helped raise interest rates thereby contributing to the overvalued dollar. Policies should be enacted to restore adequate tax revenues by returning the corporate income tax as a major contributor of these revenues and closing loopholes that allow the wealthy to escape their fair share of taxes. The rapid build-up in military expenditures must also be curbed.

At the same time the tight money policies of the Federal Reserve Board must be released and standby credit control authority enacted. Attached to my statement for inclusion in the record are the February 1984 AFL-CIO Executive Council statements detailing our proposals in these areas.

While overall these policy changes are needed to correct the fundamental conditions that have lead to the current exchange rate imbalance, there are specific actions that can be taken now to lessen the damage.

- First, the United States should pursue a policy of currency market intervention, both unilaterally and in conjunction with other countries. The Reagan Administration's inaction in this area is simply an abdication of responsibility.

- Second, attention should be focused on the Administration's refusal to invoke Section 122 of the Trade Act of 1974 which requires the President to impose a surcharge, quotas, or combination of both "whenever" fundamental international exchange rate problems or balance of payments problems dictate. Given the volatility of currency markets, the imposition of quotas would probably be the preferred course of action. While action need not be taken if the President determines that it would be contrary to the national interest, he is required to consult with Congress on that determination. The failure to do even that is but another example of the "do nothing" attitude that prevails in the U.S. government.

It should be emphasized, however, that even if the problem of an overvalued dollar is solved, the U.S., will continue to experience difficulties in trade unless appropriate reforms are made in the areas of trade and industrial policy.

The adoption of a rational and coherent industrial policy is of major importance to the future health of the U.S. economy.

An effective industrial policy to rebuild American industry and achieve sustained, balanced economic growth requires a supportive environment of general economic policies for rapid sustained growth and job creation, including an adequate, equitable revenue base and low interest rates.

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The U.S. government has maintained a basically "hands-off" or "laissez-faire" policy toward domestic industrial development and international trade. Other countries have implemented aggressive industrial and trade policies, with substantial success. In steel, auto, electronics, railcars, aircraft, and a host of emerging industries, Japan, the advanced industrial countries of Europe, and the new industrial countries have applied a wide spectrum of strategic government support -- from low-cost credit to protection from import competition, and government assistance in technology development. Manufacturing is most important for the health and balance of the U.S. economy, particularly the production of basic commodities which are essential for other production and have national defense implications. Area and regional difference in needs, wealth, and resources also must be taken into consideration in economic policy matters.

The nation must assign top priority to the channeling of resources to modernize private and public facilities and restore the national economy to a condition of balanced growth and full employment. Otherwise, the country will continue to lag in productivity growth and international trade; it will continue to leave significant portions of its human and machine resources idle for extended periods of time; it will continue to suffer a reduction in the standard of living of its people.

A successful industrial policy to rebuild American industry will require the active participation and support of all segments of the American economy, including business, labor and government.

The AFL-CIO proposes the creation of a tripartite National Industrial Policy Board -- including representatives of labor, business, and government -- which would identify and promote assistance to industries and areas that are vital to national economic growth and employment. Such assistance could include loans and loan guarantees, equity participation, direct subsidies, targeted tax measures in place of across-the-board devices, trade relief, training, research and development, and so forth.

Mr. Chairman, the AFL-CIO believes that the adoption of these measures -- trade law reform; a restructuring of monetary and fiscal policy; active intervention in international financial markets; and the inactment of industrial policy will result in achieving the basic goals of our economy -- full employment and balanced economic growth.

Enclosures
(1) AFL-CIO Executive Council Statement on High Interest Rates
(2) AFL-CIO Executive Council Statement on International Trade and Investment
(3) AFL-CIO Executive Council Statement on The National Economy
(4) 1980-1981 Balance of Trade
(5) January-December 1983/January-December 1982 U. S. Merchandise Trade Balance
(6) January-February 1984/January-February 1984 U. S. Merchandise Trade Balance
(7) Monthly Exchange Rates
(8) Balance of Merchandise Trade

Statement by the AFL-CIO Executive Council

on

High Interest Rates

February 20, 1984
Bal Harbour, FL

Real interest rates, now at the highest levels since World War II, are distorting the economy by contributing to the overvaluation of the dollar, curtailing public and private investment and pricing homes out of the reach of most workers.

The result is the loss of existing jobs and persistent high levels of unemployment.

High interest rates result from the tight-money policies of the Federal Reserve Board and the Reagan Administration's continued giant budget deficits. Excessive interest rates are a tax that Americans pay to bankers instead of to their government.

High interest rates have been a major contributing factor to the 57 percent increase since July 1980 in the value of the dollar against other major currencies. The higher dollar value raises the price of exports to foreign buyers and lowers the price of imports to U.S. buyers.

High interest rates are crowding out productive investments in the private sector and in state and local government infrastructure.

Mortgage interest rates now in a range of 11½ to 13½ percent compare to rates of 9½ percent in 1978 -- an increase of nearly one-third. Variable rate mortgages threaten to rise even higher in the future. Those new high mortgage rates price many workers out of the housing market.

The continuation of high real interest rates is sowing the seeds of the next recession.

The high interest rates caused by the policies of the Reagan Administration and the Federal Reserve Board must be reversed. The continued high budget deficits must be reduced by raising revenues and curbing the build-up in military expenditures. The

ENCLOSURE (1)

Federal Reserve Board must relax its tight monetary policy and refocus on interest rate levels. We urge the Congress to enact H.R. 1742 to re-establish the standby credit control authority that expired in June 1982 and to include on the Federal Reserve Board members from organized labor, small business, agriculture and consumer organizations.

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Statement by the AFL-CIO Executive Council

on

International Trade and Investment

February 20, 1984
Bal Harbour, FL

America's continuing crisis in international trade intensified in 1983 with a record trade deficit of $69 billion. Exports fell by more than $11 billion and imports increased by $15 billion.

The dramatic reversal in America's trading fortunes is demonstrated by the $38 billion deficit in manufactured goods, which was 2½ times greater than the deficit of 1982. Until recent years, manufacturing trade was in surplus.

Despite the resulting loss of jobs and income, the Administration continues to oppose positive action to defend U.S. economic interests. Its "free market" rhetoric does not reflect the trading practices of other countries and does nothing to solve America's trade problems.

The overvaluation of the dollar has greatly contributed to this deficit. Since July 1980, the value of the dollar has risen almost 57 percent against the currencies of our major trading partners, raising the price of exports and lowering the cost of imports. While these distorted exchange rates have had a devastating impact on the domestic economy, the Reagan Administration nevertheless continues the same monetary and fiscal policies that caused this situation. The absence of effective remedies to address domestic injury caused by the growing volume of imports further worsens the impact of these policies.

Although tariff and non-tariff barriers are all but universal among America's trading partners, the U.S. economy remains virtually defenseless, and the Reagan Administration's fixation with "free trade" hinders the adoption of realistic policies.

The AFL-CIO has consistently called for policies that reflect international trading realities and for the abandonment of outdated economic theories. These issues

ENCLOSURE (2)

must be addressed immediately before the industrial base of our country is totally undermined.

- Legislation is urgently needed to tighten and streamline laws to relieve industries and workers injured by imports. Laws dealing with unfair trade practices must be expanded and effectively enforced.

- Domestic content laws are necessary to help assure that the United States remains a producer of automobiles.

- Steel import quotas need to be adopted, provided that the steel industry undertakes modernization actions.

- Congressional action is needed to reduce the job-destroying influx of garments, textiles, and footwear now inundating U.S. industry.

- To revive the U.S. maritime industry, legislation is needed to substantially increase the portion of cargo carried in U.S. flagships and to assure a strong U.S. shipbuilding base, thereby enhancing the national security.

- Export promotion should continue as an important function of trade policy. Export-Import Bank funding should reflect the needs of domestic industry in the export arena but should also be made available for the domestic purchase of U.S. products to offset foreign subsidies.

- Policies should be enacted that assure a significant portion of U.S. raw materials destined for export, such as grains and logs, are processed in this country.

- Policies should be pursued to maintain and reestablish domestic electronic and television industries.

- The prohibition of Alaskan oil exports should be maintained, and U.S.-flag vessels should retain the essential role of distributing the oil to all regions of the country.

- The AFL-CIO reiterates its opposition to Administration requests for tariff-cutting authority. Proposals to eliminate duties on semi-conductors or establish a free trade area with other nations will only serve to increase imports and further damage U.S. industry.

- The AFL-CIO continues to oppose legislation that purports to promote trade reciprocity but merely gives additional authority to the Executive Branch to encourage greater outflows of capital and jobs from the U.S. Realistic reciprocity with other nations is long overdue and should be actively pursued, starting with the enforcement of existing trade law.

- The Administration's proposal for the renewal of the Generalized System of Preferences (GSP), which permits duty-free imports, should be defeated. The AFL-CIO reiterates its opposition to this program, which expires at the end of 1984. At a minimum, Congress must make import-sensitive products ineligible for GSP and limit its application to needy countries.

The AFL-CIO continues to advocate a system of fair trade among nations. Those who denounce our fair-trade proposals as "protectionism" contribute nothing to the solution of the international trade crisis. We insist that all nations play by the same rules.

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Statement by the AFL-CIO Executive Council

on

The National Economy

February 20, 1984
Bal Harbour, FL

The unrealistic budget and economic policies of the Reagan Administration threaten the soundness of our economy for years to come. Continuing high federal deficits are pushing up already high real interest rates and may soon tip the economy into yet another Reagan recession.

The deficit must be reduced by stronger economic growth, increased federal revenues and lower military expenditures.

Fundamental issues for working men and women -- jobs, fairness, and a future with opportunities for all -- are pushed aside by a President who places re-election above the urgent need to take action on these issues.

President Reagan's supply-side trickle-down experiment has failed. It is time to face reality by restoring adequate tax revenues, returning the corporate income tax as a major contributor of these revenues and closing loopholes that allow the wealthy to escape their fair share of taxes. The rapid build-up in military expenditures must be curbed and the destruction of domestic programs must be stopped.

Giant budget deficits raise interest rates, which in turn curtail public and private job creating investments and price homes out of the reach of most workers. High interest rates contribute to the overvaluation of the dollar, which prices U.S. goods out of foreign markets and encourages a flood of imports that undermines domestic employment and production.

A year after the bottom of the Reagan recession, 9 million Americans are still officially unemployed, 1.5 million "discouraged" workers are no longer even counted among the jobless, and almost 6 million workers who want full-time jobs are working only

ENCLOSURE (3)

part-time. In January, there were one million more unemployed than when Reagan took office, and two million more than four years ago. The buying power of the average worker's paycheck is lower than in 1979. More Americans are living in poverty today than at any time since poverty statistics were first compiled in the mid-1960s.

Jobs, fairness, and opportunities for the future remain key issues for America's workers and for the nation in 1984.

Jobs

Healthy economic growth based on sound monetary, fiscal and industrial revitalization policies are necessary elements of full employment policies. To achieve progress toward full employment, rebuild the economy and help workers and their communities, we support the following measures now pending before Congress:

1. The industrial policy bill (H.R. 4360), which would set up a high-level Council on Industrial Competitiveness and a Bank for Industrial Competitiveness to make loans and loan guarantees for modernizing and revitalizing American industry.

2. The House-passed community service jobs bill (H.R. 1036 & S. 1812), which would provide public service jobs for workers who cannot find work in the private sector.

3. The public works bill (H.R. 2544), that would help reconstruct the nation's basic infrastructure, including water and sewer facilities, highways and port facilities, and other public works which stimulate private, job-creating investment and economic activity.

4. The plant closing bill (H.R. 2847), which would provide some protection for workers and local communities when industries shut down or move.

5. The House-passed domestic auto content bill (H.R. 1234 & S. 707), to assure a strong U.S. auto industry and additional trade legislation to provide relief for other impacted industries.

Fairness

The Reagan Administration has undermined many statutory protections through Administrative actions and has crippled enforcement of labor standards, civil rights, women's rights, occupational safety and health, environmental safeguards, consumer protections and long-standing anti-trust restraints on corporate power. To restore some element of fairness, major changes must be made. Only the election of a new President will restore proper administration of these basic statutory rights and safeguards. But Congress also has a responsibility for oversight of Administration actions and for enacting additional worker and consumer protections.

The tax giveaways to the wealthy and corporations enacted in 1981 must be reversed. A progressive income tax based on ability to pay must remain a fundamental principle of the tax system. New proposals to heap more of the burden on workers through such regressive devices as value-added taxes, consumption taxes, and flat-rate income taxes must be rejected. Congress should adjust the tax schedule to cap the last installment of the Reagan tax cut at $700, which would recapture $6.9 billion in 1985 revenues, and repeal the costly indexation provisions of the 1981 Act, which would recover another $6.3 billion. Corporations, whose share of the tax burden dropped from 20 percent in 1960 to 10 percent in 1983, must bear their fair share. Tax subsidies for the overseas operation of U.S. multinational corporations must be curbed through elimination of foreign tax credits and deferrals.

The only major revenue proposal of the Reagan Administration is to tax the health insurance of workers and their families. The AFL-CIO will strongly oppose this proposal.

Congress has before it a number of bills that we believe would enhance the fair treatment of the nation's citizens. Therefore we support:

1. The House-passed health care protection for the unemployed (H.R. 3521). This bill would create a modest program of health care for the unemployed and their families.
2. Cost-containment legislation to fight inflation in the health care industry while protecting wages, benefits, and other contractual rights of health care workers and including special protections for public hospitals. However, we will oppose further cutbacks in essential Medicare and Medicaid health care services.

3. Energy price regulation (H.R. 2154 and S. 996), the "Natural Gas Consumer Relief Act" to protect consumers from the monopoly power of natural gas producers, as well as the House-passed restrictions on the export of Alaska Oil (H.R. 3231) to assure that Alaskan oil is used for American consumers.

4. Legislation along the lines of H.R. 100, to end discrimination in pensions and insurance. While that discrimination rests first and foremost on women workers, it affects the entire family through diminished benefits or increased premiums.

5. Consumer protections on telephone rates and service with adequate protection for telephone workers and their pension rights.

6. Worker and union protections in bankruptcy cases to prevent corporations from trying to escape their obligations through phony bankruptcy proceedings. Consumer and worker protections must be provided in any bankruptcy reform legislation, such as H.R. 1147 and S. 333.

7. Legislation (H.R. 1743 and S. 1079) that would prohibit companies which violate the National Labor Relations Act from receiving federal contracts for up to three years.

The Future

In addition to jobs and fairness, America's working people want a secure future, a decent retirement, hope for education and opportunity for their children. To enhance the future of the nation's citizens, new, strong national leadership is required.

Congress now has before it legislation which would make a start toward these goals. We support:

1. Adequate funding for the Elementary and Secondary Education Act, for vocational education, for Adult Basic Education, for student loans and grants, and for other post-secondary and higher-education programs. We oppose President Reagan's schemes for educational vouchers and tuition tax credits as destructive of public education and oppose block grants as inefficient and ineffective methods of funding proven programs.

2. More funds for training and retraining of adult workers, particularly those affected by industrial dislocation.

3. Adequate protections for pension rights. The single-employer pension plan termination insurance program must be strengthened to (a) provide strong disincentives to termination of pensions plans by requiring solvent employers who terminate pension plans to be responsible for the full amount of accrued benefits of plan participants, and

(b) curtail the ability of employers to dump unfunded pension liabilities on the Pension Benefit Guaranty Corporation. We will oppose attempts to modify the Multi-Employer Pension Plan Amendments of 1980.

The AFL-CIO is convinced that the nation can move toward full employment, restore fairness and build a better tomorrow for ourselves and our children. The program we have outlined will move the country toward these goals and at the same time reduce the federal deficit by stimulating the economy and raising needed revenues.

Congress should start to deal with these issues now, but only with the election of a new Administration can these principles be achieved.

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Attachments: Background Paper

Background Paper on The National Economy

The Administration proposes to increase defense outlays in 1985 to $272 billion, an increase of 15 percent.

This Council has called for reducing real defense spending increases to a range of 5 to 7 percent, with some members urging that the increase be held to the lower end of the range or below.

Savings from this lowered defense spending would be $7 to $12 billion in the first year, with substantially greater reductions in future years, assuming an inflation rate of 5 percent.

To pay for real increases in defense spending, we have supported a progressive surtax levied on corporate and individual income taxes, plus an additional tax on income currently sheltered. Such a surtax would raise $12 billion to $17 billion in the first year.

A number of the programs that the AFL-CIO calls for would provide for increased expenditures. But to the extent that people are put back to work under these programs, they would become taxpayers rather than recipients of unemployment compensation or in some cases welfare benefits. Each one-percent reduction of unemployment raises tax revenues by about $25 billion and reduces outlays by $5 billion.

Following are the budget estimates for the detailed programs spelled out in the AFL-CIO recommendations:

The Industrial Policy Act (H.R. 4360) would set up a new process for dealing with industrial economic issues through a new Council on Industrial Competitiveness, whose cost would be small. The Bank for Industrial Competitiveness would have a federal authorization for $8.5 billion in federal stock subscription made available over several years.

The Community Service Jobs Act (H.R. 1036 and S. 1812) calls for an authorization of $3.5 billion to employ people in community service work who cannot find jobs in the private sector .

The Public Works Act (H.R. 2544) would carry an authorization of $3.2 billion to help reconstruct the nation's basic infrastructure, including water and sewer facilities, highways and port facilities, and other public works which stimulate private, job-creating investment and economic activity.

The Plant Closing Act (H.R. 2847) would have little budget impact; it would require employers to provide advance notice and some basic protections for workers and local communities.

The domestic auto content bill (H.R. 1234 and S. 707) would have no measurable budget outlays but would assure continued extensive U.S. auto production.

The Health Care Protection Bill (H.R. 3521) calls for authorization of $1.8 billion a year for each of two years to provide health insurance coverage for the unemployed.

The health care cost containment legislation would save the federal government $1 billion. We oppose the President's call for cuts of $1.1 billion in Medicare and $1.1 billion in Medicaid.

The energy bills, women's pension and insurance protections, consumer and worker protections in telephone, and consumer and worker protections in bankruptcy have little budget impact, but provide substantial worker and consumer safeguards.

We are opposed to the President's call for cuts of $200 million in authorization for elementary, secondary and vocational education and for cuts of $900 million in higher education loans and grants.

We are opposed to the President's call for cuts of $600 million in employment and training programs.

There is a saving to the government in our proposals for improving the single-employer pension guarantee program.

In addition, the AFL-CIO has proposed a second rollback of the personal and corporate income tax reductions enacted in 1981, and the closing of some earlier corporate tax loopholes, which would add up to an estimated $49 billion in additional tax revenues in fiscal year 1985.

This is just a partial recapture of the $165 billion in revenue loss that occurs in 1985 as a result of the 1981 Tax Act. Congress made a start in 1982 to correct this revenue shortfall problem.

Additional Federal Revenues
From AFL-CIO Tax Proposals

	Fiscal Year 1985 in Billions
$700 Cap -- Third Year	$ 6.9
Repeal Indexing	6.2
Trim "Savings" Exclusions	2.7
Phase Down Capital Gains	3.9
Scale Back Estate and Gift Exclusion	3.7
Foreign Tax:	
DISC	1.4
Deferral	1.0
Foreign Tax Credit	7.1
Investment Tax Credit:	
Depreciation Basis Adjustment	1.3
Reduce 10% to 7%	7.1
Limit Graduate Rates to Small Corporations	2.0
Oil and Gas Depletion & Expensing of Drilling Costs	6.0
	$49.3

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ENCLOSURE (4)

BALANCE OF TRADE
(in millions of dollars)

JANUARY-DECEMBER

	1980			1981		
	Exports	Imports	Balance	Exports	Imports	Balance
Food and live animals	$ 27,743.7	$ 16,921.9	+$10,821.8	$ 30,290.8	$ 16,528.2	+$13,762.6
Beverage and Tobacco	2,663.0	3,040.2	- 377.2	2,914.7	3,418.2	- 503.5
Crude materials, inedible, except fuels	23,790.7	11,301.2	+ 12,489.5	20,992.4	12,052.4	+ 8,940.0
Mineral fuels, lubricants, and related material	7,982.3	86,372.1	- 78,389.8	10,279.0	84,441.0	- 74,162.0
Animal and vegetable oils and fats	1,946.3	575.0	+ 1,371.3	1,750.3	524.2	+ 1,226.1
Chemicals and related products	20,740.2	9,021.0	+ 11,719.2	21,187.1	9,882.1	+ 11,305.0
Manufactured goods classified chiefly by material	22,254.6	34,131.3	- 11,876.7	20,632.5	39,349.1	- 18,716.6
Machinery and transport equipment	84,552.9	63,271.8	+ 21,281.1	95,717.2	72,185.6	+ 23,531.6
Miscellaneous manufactured articles	16,343.1	25,037.8	- 8,694.7	16,745.9	27,579.1	- 10,833.2
Commodities and transactions not classified elsewhere	8,419.5	7,312.0	+ 1,107.5	8,388.6	7,392.1	+ 996.5
Foreign (re-exports)	4,114.7		+ 4,114.7	4,778.4		+ 4,778.4
TOTAL	$220,551.0	$256,984.3	- 36,433.3	$233,676.9	$273,352.0	- 39,675.1

SOURCE: U.S. Exports, General Imports, and Merchandise Trade Balance by Month
Tables 3 and 4, Exports of Domestic and Foreign Merchandise by Month, January 1980 to December 1981 (f.a.s.)
U.S. General Imports of Merchandise by Month, January 1980 to December 1981 (c.i.f.)
Unadjusted
U.S. Department of Commerce

BALANCE OF TRADE
(in millions of dollars)

MANUFACTURINC

JANUARY-DECEMBER

	1980			1981		
	Exports	Imports	Balance	Exports	Imports	Balance
Chemicals and related products	$ 20,740.2	$ 9,021.0	+$11,719.2	$ 21,187.1	$ 9,882.1	+$11,305.0
Manufactured goods classified chiefly by material	22,254.6	34,131.3	- 11,876.7	20,632.5	39,349.1	- 18,716.6
Machinery and transport equipment	84,552.9	63,271.8	+ 21,281.1	95,717.2	72,185.6	+ 23,531.6
Miscellaneous manufactured articles	16,343.1	25,037.8	- 8,694.7	16,745.9	27,579.1	- 10,833.2
TOTAL	$143,890.8	$131,461.9	+$12,428.9	$154,282.7	$148,995.9	+$ 5,286.8

SOURCE: U.S. Exports, General Imports, and Merchandise Trade Balance by Month
Tables 3 and 4, Exports of Domestic and Foreign Merchandise by Month, January 1980 to December 1981 (f.a.s.)
U.S. General Improts of Merchandise by Month, January 1980 to December 1981 (c.i.f.)
Unadjusted
U.S. Department of Commerce

ENCLOSURE (5)

U.S. Merchandise Trade Balance

January-December 1983 Compared to January-December 1982

The U.S. merchandise trade deficit for the 12 months of 1983 was $69.4 billion, $26.8 billion (62.7%) greater than in the corresponding period a year earlier. Merchandise exports dropped by $11.7 billion (5.5%) while imports increased by $15.0 billion (5.9%).

Analysis of shifts in the composition of trade reveals the following:

Fuel imports fell by $7.4 billion (10.9%) while exports fell by $3.2 billion or 25.4%. This reduced the deficit in fuel trade by $4.2 billion to $51.0 billion (a drop of 7.6%).

The U.S. trade surplus in food fell by 9.1% dropping from a $8.2 billion surplus for the 12 months of 1982 to $7.5 billion surplus for the 12 months of 1983. Exports rose $0.2 billion (0.9%), and imports rose $1.0 billion (6.1%).

The pattern in manufacturing trade in 1983 represents a continuing sharp deterioration from 1982. In the 12 months of 1982, the U.S. ran a $10.5 billion deficit in manufacturing. For the 12 months of 1983, the manufacturing deficit increased 261.5% to $38.2 billion. Manufactured imports rose by $20.3 billion (13.5%) while manufactured exports fell by $7.3 billion (5.2%). Shifts in the composition of manufacturing trade include:

Chemicals and related products: U.S. trade surplus fell $1.5 billion (15.2%) to $8.4 billion. Exports dropped 0.7% but imports rose 13.8%.

Manufactured goods classified chiefly by material (tires, paper, textile fabrics, iron and steel, nonferrous metals): U.S. trade deficit increased by $3.6 billion (19.9%) to $21.9 billion. Exports fell by $1.9 billion (11.3%), and imports rose by $1.8 billion (5.0%).

Machinery and transport equipment (industrial machinery, computers, communication equipment, autos, aerospace): U.S. trade surplus collapsed, falling $17.8 billion (155.8%) from an $11.4 billion surplus for the 12 months of 1982 to a deficit of $6.4 billion for the 12 months of 1983. Exports fell by $4.6 billion (5.2%) while imports into the U.S. increased by $13.2 million (17.4%).

Miscellaneous manufactured articles (clothing, footwear, instruments, toys): U.S. trade deficit has increased by $4.7 billion (34.5%) to $18.4 billion. Exports dropped by $0.7 billion, for a decline of 4.5%. Imports rose $4.0 billion, or 13.5%.

From December 1980 to December 1983, the civilian labor force grew by 4.6 million workers, while U.S. employment in manufacturing declined by 0.9 million workers over this same period.

MERCHANDISE

BALANCE OF TRADE
(IN MILLIONS OF DOLLARS)

COMPARISON OF DECEMBER 1982 TO DECEMBER 1983

	1982 EXPORTS	1982 IMPORTS	1982 BALANCE	1983 EXPORTS	1983 IMPORTS	1983 BALANCE
Food & Live Animals	$ 1,747.5	$ 1,244.1	$ 503.4+	$ 2;141.3	$ 1,344.5	$ 796.8+
Beverage & Tobacco	218.4	286.4	68.0-	245.8	327.2	81.4-
Crude Materials, Inedible, Except Fuels	1,447.1	721.7	725.4+	1,666.5	922.3	744.2+
Minerals Fuels, Lubricants & Related Materials	855.4	5,645.4	4,790.0-	765.6	4,596.7	3,831.1-
Animal & Vegetable Oils & Fats	117.3	32.1	85.2+	137.4	59.8	77.6+
Chemicals & Related Products	1,610.2	825.2	785.0+	1,666.2	972.0	694.2+
Manufactured Goods Classified Chiefly by Material	1,181.4	2,476.6	1,295.2-	1,249.8	3,192.6	1,942.8-
Machinery & Transport Equipment	6,640.5	5,828.5	812.0+	7,110.3	8,616.2	1,505.9-
Misc. Manufactured Articles	1,215.7	2,341.1	1,125.4-	1,287.4	2,895.8	1,608.4-
Commodities & Transactions Not Classified Elsewhere	879.3	600.7	278.6+	506.6	553.6	47.0-
Foreign (Re-exports)	433.8		433.8+	402.9		402.9+
TOTALS	$ 16,346.6	$ 20,001.8	$ 3,655.2-	$ 17,179.8	$ 23,480.7	$ 6,300.9-

SOURCE:
U.S. Exports, General Imports, and Merchandise Trade Balance by Month
Tables 3 and 4, Exports of Domestic and Foreign Merchandise by Month, December 1982 to December 1983 (f.a.s.)
U.S. General Imports of Merchandise by Month, December 1982 to December 1983 (c.i.f.)
Seasonally Adjusted
U.S. Department of Commerce

MANUFACTURING

BALANCE OF TRADE
(IN MILLIONS OF DOLLARS)

COMPARISON OF DECEMBER 1982 TO DECEMBER 1983

	1982 EXPORTS	1982 IMPORTS	1982 BALANCE	1983 EXPORTS	1983 IMPORTS	1983 BALANCE
Chemicals & Related Products	$ 1,610.2	$ 825.2	$ 785.0+	$ 1,666.2	$ 972.0	$ 694.2+
Manufactured Goods Classified Chiefly by Material	1,181.4	2,476.6	1,295.2-	1,249.8	3,192.6	1,942.8-
Machinery & Transport Equipment	6,640.5	5,828.5	812.0+	7,110.3	8,616.2	1,505.9-
Misc. Manufactured Articles	1,215.7	2,341.1	1,125.4-	1,287.4	2,895.8	1,608.4-
TOTALS	$10,647.8	$11,471.4	$ 823.6-	$11,313.7	$15,676.6	$4,362.9-

SOURCE:
U.S. Exports, General Imports, and Merchandise Trade Balance by Month
Tables 3 and 4, Exports of Domestic and Foreign Merchandise by Month, December 1982 to December 1983 (f.a.s.)
U.S. General Imports of Merchandise by Month, December 1982 to December 1983 (c.i.f.)
Seasonally Adjusted
U.S. Department of Commerce

MERCHANDISE

BALANCE OF TRADE
(IN MILLIONS OF DOLLARS)

CUMULATIVE COMPARISON OF JANUARY-DECEMBER 1982 TO JANUARY-DECEMBER 1983

	1982 EXPORTS	1982 IMPORTS	1982 BALANCE	1983 EXPORTS	1983 IMPORTS	1983 BALANCE
Food & Live Animals	$ 23,950.4	$ 15,731.1	$ 8,219.3+	$ 24,165.8	$ 16,691.7	$ 7,474.1+
Beverage & Tobacco	3,026.2	3,665.7	639.5-	2,813.0	3,709.7	896.7-
Crude Materials, Inedible, Except Fuels	19,248.4	9,301.9	9,946.5+	18,596.0	10,271.5	8,324.5+
Minerals Fuels, Lubricants & Related Material	12,728.8	67,656.6	54,927.8-	9,499.8	60,271.5	50,771.7-
Animal & Vegetable Oils & Fats	1,540.9	446.4	1,094.5+	1,459.1	540.9	918.2+
Chemicals & Related Products	19,890.5	9,934.5	9,956.0+	19,750.9	11,305.1	8,445.8+
Manufactured Goods Classified Chiefly by Material	16,738.6	34,996.5	18,257.9-	14,851.7	36,750.0	21,898.3-
Machinery & Transport Equipment	87,128.1	75,723.2	11,404.9+	82,563.0	88,927.7	6,364.7-
Misc. Manufactured Articles	15,958.5	29,630.5	13,672.0-	15,242.7	33,637.3	18,394.6-
Commodities & Transactions Not Classified Elsewhere	6,865.8	7,798.2	932.4-	6,975.1	7,829.8	854.7-
Foreign (Re-exports)	5,116.9		5,116.9+	4,568.4		4,568.4+
TOTALS	$212,193.1	$254,884.5	$42,691.4-	$200,485.7	$269,878.2	$69,449.7-

SOURCE:
U.S. Exports, General Imports, and Merchandise Trade Balance by Month
Tables 3 and 4, Exports of Domestic and Foreign Merchandise by Month, January-December 1982 to January-December 1983 (f.a.s.)
U.S. General Imports of Merchandise by Month, January-December 1982 to January-December 1983 (c.i.f.)
Seasonally Adjusted
U.S. Department of Commerce

MANUFACTURING

BALANCE OF TRADE
(IN MILLIONS OF DOLLARS)

CUMULATIVE COMPARISON OF JANUARY-DECEMBER 1982 TO JANUARY-DECEMBER 1983

	1982 EXPORTS	1982 IMPORTS	1982 BALANCE	1983 EXPORTS	1983 IMPORTS	1983 BALANCE
Chemical & Related Products	$ 19,890.5	$ 9,934.5	$ 9,956.0+	$ 19,750.9	$ 11,305.1	$ 8,445.8+
Manufactured Goods Classified Chiefly by Material	16,738.6	34,996.5	18,257.9-	14,851.7	36,750.0	21,898.3-
Machinery & Transport Equipment	87,128.1	75,723.2	11,404.9+	82,563.0	88,927.7	6,364.7-
Misc. Manufactured Articles	15,958.5	29,630.5	13,672.0-	15,242.7	33,637.3	18,394.6-
TOTALS	$139,715.7	$150,284.7	$10,569.0-	$132,408.3	$170,620.1	$38,211.8-

SOURCE:
U.S. Exports, General Imports, and Merchandise Trade Balance by Month
Tables 3 and 4, Exports of Domestic and Foreign Merchandise by Month, January-December 1982 to January-December 1983 (f.a.s.)
U.S. General Imports of Merchandise by Month, January-December 1982 to January-December 1983 (c.i.f.)
Seasonally Adjusted
U.S. Department of Commerce

MONTHLY EXCHANGE RATES
(Currency Units per U.S. Dollar)

	Dec. 1983	Nov. 1983	Oct. 1983	July 1980 *	Percent Change Since July 1980
German Mark	2.7484	2.6829	2.6025	1.7475	57.3
French Franc	8.3831	8.1608	7.9512	4.0557	106.7
Dutch Guilder	3.0849	3.0060	2.9195	1.9111	61.4
Swiss Franc	2.1967	2.1694	2.1111	1.6078	36.6
Canadian Dollar	1.2468	1.2366	1.2320	1.1523	8.2
British Pound	0.6971	0.6772	0.6680	0.4214	65.4
Belgian Franc	55.96	54.55	53.03	27.96	100.1
Japanese Yen	234.36	235.03	232.92	221.13	6.0
Italian Lire	1,666.2	1,625.2	1,582.5	831.6	100.4
Exchange Value of U.S. Dollar	132.84	130.26	127.50	84.65	56.9

* Date of the lowest weighted-average exchange value of the dollar since exchange rates were allowed to float.

Source: Federal Reserve Board

ENCLOSURE (6)

U.S. Merchandise Trade Balance

January-February 1984 Compared to January-February 1983

The U.S. merchandise trade deficit for the first 2 months was $19.6 billion, $12.3 billion (171.2%) greater than in the corresponding period a year earlier. Merchandise exports increased $2.0 billion (5.9%), while imports increased by 35.2%.

Analysis of shifts in the composition of trade reveals the following:

Fuel imports increased by $1.3 billion (14.0%) while exports fell by $705.8 million or 35.7%. This deficit in fuel trade increased by $2.0 billion to $9.2 billion (a rise of 27.6%).

The U.S. trade surplus in food fell by 33.4% dropping from a $1.3 billion surplus for the 2 months of 1983 to a $883.4 million surplus for the 2 months of 1984. Exports fell $22 million (0.5%), and imports rose $422 million (15.2%).

The pattern in manufacturing trade in 1984 represents a sharp deterioration from 1983. In the first 2 months of 1983, the U.S. ran a $3.6 billion deficit compared to a deficit of $13.7 billion in the first 2 months of 1984. Shifts in the composition of manufacturing trade include:

Chemicals and related products: U.S. trade surplus rose $71.4 million (5.1%) to $1.5 billion. Exports rose 12.0%, and imports rose 17.3%.

Manufactured goods classified chiefly by material (tires, paper, textile fabrics, iron and steel, nonferrous metals): U.S. trade deficit increased by $2.9 billion (111%) to $5.5 billion. Exports increased by $83.2 million (3.3%), and imports rose by $3.0 billion (58.2%).

Machinery and transport equipment (industrial machinery, computers, communication equipment, autos, aerospace): U.S. trade surplus collapsed, falling $5.1 billion (914%) from $556.1 million surplus in the first 2 months of 1983 to a deficit of $4.5 billion in the first 2 months of 1984. Exports rose by $1.1 billion (7.9%) while imports into the U.S. increased by $6.2 billion (47.0%).

Miscellaneous manufactured articles (clothing, footwear, instruments, toys): U.S. trade deficit increased $2.2 billion (75.3%) to $5.1 billion. Exports dropped by $5.0 million; 0.2% decline. Imports rose $2.2 billion, or 40.4%.

From February 1981 to February 1984, the civilian labor force grew by 4.1 million workers, while U.S. employment in manufacturing declined by 0.5 million workers over this same period.

3/30/84

MERCHANDISE

BALANCE OF TRADE
(IN MILLIONS OF DOLLARS)

COMPARISON OF FEBRUARY 1983 TO FEBRUARY 1984

	1983 EXPORTS	1983 IMPORTS	1983 BALANCE	1984 EXPORTS	1984 IMPORTS	1984 BALANCE
Food & Live Animals	$ 1,979.4	$ 1,308.0	$ 671.4+	$ 1,871.5	$ 1,601.0	$ 270.5+
Beverage & Tobacco	223.6	255.1	31.5-	231.4	306.3	74.9-
Crude Materials, Inedible, Except Fuels	1,434.1	740.0	694.1+	1,752.3	1,052.4	699.9+
Minerals Fuels, Lubricants & Related Materials	832.6	3,841.3	3,008.7-	609.5	5,190.4	4,580.9-
Animal & Vegetable Oils & Fats	139.5	33.6	105.9+	170.3	48.7	121.6+
Chemicals & Related Products	1,595.5	933.1	662.4+	1,759.9	1,052.3	707.6+
Manufactured Goods Classified Chiefly by Material	1,181.9	2,514.0	1,332.1-	1,251.2	4,069.0	2,817.8-
Machinery & Transport Equipment	6,786.2	6,833.4	47.2-	7,132.9	9,138.8	2,005.9-
Misc. Manufactured Articles	1,223.1	2,704.8	1,481.7-	1,228.4	4,154.9	2,926.5-
Commodities & Transactions Not Classified Elsewhere	573.8	518.8	55.0+	779.1	690.7	88.4+
Foreign (Re-exports)	341.8		341.8+	425.9		425.9+
TOTALS	$ 16,311.5	$ 19,682.1	$ 3,370.6-	$ 17,212.4	$ 27,304.5	$10,092.1-

SOURCE:
U.S. Exports, General Imports, and Merchandise Trade Balance by Month
Tables 3 and 4, Exports of Domestic and Foreign Merchandise by Month, February 1983 to February 1984 (f.a.s.)
U.S. General Imports of Merchandise by Month, February 1983 to February 1984 (c.i.f.)
Seasonally Adjusted
U.S. Department of Commerce

MANUFACTURING

BALANCE OF TRADE
(IN MILLIONS OF DOLLARS)

COMPARISON OF FEBRUARY 1983 TO FEBRUARY 1984

	1983 EXPORTS	1983 IMPORTS	1983 BALANCE	1984 EXPORTS	1984 IMPORTS	1984 BALANCE
Chemicals & Related Products	$ 1,595.5	$ 933.1	$ 662.4+	$ 1,759.9	$ 1,052.3	$ 707.6+
Manufactured Goods Classified Chiefly by Material	1,181.9	2,514.0	1,332.1-	1,251.2	4,069.0	2,817.8-
Machinery & Transport Equipment	6,786.2	6,833.4	47.2-	7,132.9	9,138.8	2,005.9-
Misc. Manufactured Articles	1,223.1	2,704.8	1,481.7-	1,228.4	4,154.9	2,926.5-
TOTALS	$10,786.7	$12,985.3	$2,198.6-	$11,372.4	$18,415.0	$7,042.6-

SOURCE:
U.S. Exports, General Imports, and Merchandise Trade Balance by Month
Tables 3 and 4, Exports of Domestic and Foreign Merchandise by Month, February 1983 to February 1984 (f.a.s.)
U.S. General Imports of Merchandise by Month, February 1983 to February 1984 (c.i.f.)
Seasonally Adjusted
U.S. Department of Commerce

MERCHANDISE

BALANCE OF TRADE
(IN MILLIONS OF DOLLARS)

CUMULATIVE COMPARISON OF FEBRUARY 1983 TO FEBRUARY 1984

	1983 EXPORTS	1983 IMPORTS	1983 BALANCE	1984 EXPORTS	1984 IMPORTS	1984 BALANCE
Food & Live Animals	$ 4,096.5	$ 2,769.1	$ 1,327.4+	$ 4,074.5	$ 3,191.1	$ 883.4+
Beverage & Tobacco	395.1	638.8	243.7-	429.9	621.2	191.3-
Crude Materials, Inedible, Except Fuels	2,937.1	1,512.1	1,425.0+	3,588.2	2,008.2	1,580.0+
Minerals Fuels, Lubricants & Related Material	1,974.9	9,176.4	7,201.5-	1,269.1	10,458.6	9,189.5-
Animal & Vegetable Oils & Fats	238.6	76.4	162.2+	339.2	137.8	201.4+
Chemicals & Related Products	3,239.5	1,837.6	1,401.9+	3,628.0	2,154.7	1,473.3+
Manufactured Goods Classified Chiefly by Material	2,499.9	5,111.5	2,611.6-	2,583.1	8,087.5	5,504.4-
Machinery & Transport Equipment	13,669.3	13,113.2	556.1+	14,746.2	19,273.1	4,526.9
Misc. Manufactured Articles	2,517.3	5,448.5	2,931.2-	2,512.3	7,650.5	5,138.2-
Commodities & Transactions Not Classified Elsewhere	1,245.3	1,073.5	171.8-	1,463.1	1,516.2	53.1-
Foreign (Re-exports)	728.0		728.0+	904.8		904.8+
TOTALS	$ 33,543.6	$ 40,757.2	$ 7,213.6-	$ 35,538.4	$ 55,098.9	$19,560.5-

SOURCE:
U.S. Exports, General Imports, and Merchandise Trade Balance by Month
Tables 3 and 4, Exports of Domestic and Foreign Merchandise by Month, February 1983 to February 1984 (f.a.s.)
U.S. General Imports of Merchandise by Month, February 1983 to February 1984 (c.i.f.)
Seasonally Adjusted
U.S. Department of Commerce

MANUFACTURING

BALANCE OF TRADE
(IN MILLIONS OF DOLLARS)

CUMULATIVE COMPARISON OF FEBRUARY 1983 TO FEBRUARY 1984

	1983 EXPORTS	1983 IMPORTS	1983 BALANCE	1984 EXPORTS	1984 IMPORTS	1984 BALANCE
Chemical & Related Products	$ 3,239.5	$ 1,837.6	$ 1,401.9+	$ 3,628.0	$ 2,154.7	$ 1,473.3+
Manufactured Goods Classified Chiefly by Material	2,499.9	5,111.5	2,611.6-	2,583.1	8,087.5	5,504.4-
Machinery & Transport Equipment	13,669.3	13,113.2	561.1+	14,746.2	19,273.1	4,526.9-
Misc. Manufactured Articles	2,517.3	5,448.5	2,931.2-	2,512.3	7,650.5	5,138.2-
TOTALS	$ 21,926.0	$ 25,510.8	$ 3,584.8-	$ 23,469.6	$ 37,165.8	$13,696.2-

SOURCE:
U.S. Exports, General Imports, and Merchandise Trade Balance by Month
Tables 3 and 4, Exports of Domestic and Foreign Merchandise by Month, February 1983 to February 1984 (f.a.s.)
U.S. General Imports of Merchandise by Month, February 1983 to February 1984 (c.i.f.)
Seasonally Adjusted
U.S. Department of Commerce

ENCLOSURE (7)

MONTHLY EXCHANGE RATES
(Currency Units per U.S. Dollar)

	Feb. 1984	Jan. 1984	Dec. 1983	July 1980 *	Percent Change Since July 1980
German Mark	2.7027	2.8108	2.7484	1.7475	54.7
French Franc	8.3162	8.5945	8.3831	4.0557	105.1
Dutch Guilder	3.0499	3.1595	3.0849	1.9111	59.6
Swiss Franc	2.2059	2.2367	2.1967	1.6078	37.2
Canadian Dollar	1.2481	1.2484	1.2468	1.1523	8.3
British Pound	0.6947	0.7100	0.6971	0.4214	64.9
Belgian Franc	55.36	57.37	55.96	27.96	98.0
Japanese Yen	233.62	233.77	234.36	221.13	5.6
Italian Lire	1,668.8	1,706.4	1,666.2	831.6	100.7
Exchange Value of U.S. Dollar	$131.71	$135.07	$132.84	$84.65	55.6

* Date of the lowest weighted-average exchange value of the dollar since exchange rates were allowed to float.

Source: Federal Reserve Board

BALANCE OF MERCHANDISE TRADE BASED ON F.O.B. EXPORTS AND C.I.F. IMPORTS

UNITED STATES	(Value in billions of dollars)	
1970	- 0.2	estimated
1978	-39.2	
1979	-42.4	
1980	-40.4	
1981	-36.4	
1982	-42.7	
1983	-69.4	

TRADE BALANCE IN MANUFACTURED GOODS (C.I.F. AND F.A.S.)

UNITED STATES	(Value in billions of dollars)
1970	2.3
1977	- 1.8
1978	-12.3
1979	- 2.1
1980	12.5
1981	5.3
1982	-10.5
1983	-38.2

Source: U.S. Department of Commerce, International Trade Administration, International Economic Indicators, December 1983

ENCLOSURE (8)

Chairman GIBBONS. Thank you for that excellent summary.
Mr. Price.

STATEMENT OF LEE PRICE, INTERNATIONAL ECONOMIST, INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE & AGRICULTURAL IMPLEMENT WORKERS OF AMERICA, UAW

Mr. PRICE. Thank you Chairman Gibbons. We appreciate the opportunity to testify on the current trade deficit on behalf of the UAW. We think that the trade situation has reached crisis proportions and does deserve the close attention of this Government.

When we look at these tables and charts of the trade balance——

Chairman GIBBONS. Let me say that I recognize both of you are summarizing your statements and let me assure you they will be included in full in the record.

Mr. PRICE. Thank you.

Because you have had so much other testimony covering the basic background, I want to emphasize things that have been different.

Chairman GIBBONS. We appreciate that.

Mr. PRICE. It is essentially the manufacturing sector that has more than borne the brunt of that decline. In fact, if you take the current rate of trade deficit, $115 to $120 billion, for a decline since 1980 of about $80 billion, but the manufacturing sector deficit has grown by $90 billion. It went from roughly $12 billion surplus to a $80 billion deficit this year, so the manufacturing sector has really been hit hard by the decline in the trade situation.

That decline of $90-plus billion in the manufacturing trade posture represents 2½ million lost jobs. 2½ million jobs mean 2½ percent of unemployment. Take the CBO's multiplier of roughly $30 billion impact in budget deficits you are talking about $75 billion. So it has serious fiscal impacts.

I would like to run through some of the problems in the four industries in which we have most of our members: the auto industry, agricultural implement industry, the construction equipment industry, and the aerospace industry. Goods crossing the border in those four sectors represent 30 percent of the U.S. manufacturing trade.

I will take them in order of their problems.

The auto industry is one of the Nation's largest exporters. It exported $17 billion last year. It also imported $42 billion, an amount exceeded only by oil imports. That had a lot to do with the fact that production workers imports has declined since 1979 to last year's $582,000 for production workers.

Turning to the construction equipment industry, that industry has traditionally been a major exporter with 35 percent of its output exported. However, in the last several years, the exports have declined 60 percent, which in turn has contributed to declining employment in that industry. If you look at the back of the statement, employment of production workers of construction equipment has fallen by over half.

In farm machinery, exports have also declined. In one particular sector, the agricultural tractor sector, there has been major increases in imports. Primarily because the U.S companies have shut down their production of medium-size tractors here and gone to Europe to import tractors. We have had in just a couple of years close to a $500 million turnaround in our trade balance in tractors. Again, our production worker employment in that sector has fallen by a third.

The aerospace industry has $15 billion in exports and $3 billion in imports. If you separate out what is happening within the aerospace sector, you find again real problems within the civilian sector. Exports are off 25 or 30 percent in the civilian aircraft exports. They have been made up somewhat by the replacement parts sold abroad and military aircraft.

If you look at the sources of these trade problems in our industries and manufacturing as a whole, we think that there are really four underlying causes. One, we think too often neglected by the previous witnesses is that we lack a satisfactory policy to limit trade injury in specific sectors.

Second, we believe the monetarist stringency that we have had in the last 5 years has cranked up the value of the dollar and kept it there. It is too easy to blame the dollar on the deficits that started in 1981 and forget the fact that it was 1980 when the dollar went up and it has stayed there. Chairman Volcker's testimony before you on Tuesday confirmed that he continues to be most concerned about inflation, he is willing, as I read him, to let that dollar stay up there because he is more worried about inflation than the competitiveness of our industries. So it was the Federal actions in 1979 and 1980 that brought the dollar up and has helped keep it up there.

Third, we have the problem that many of your witnesses have talked about which is the fiscal situation. We have had both inequitable and profligate fiscal policy the last 3 years. Implicitly in the presentations of all the business witnesses, bankers, some of the administration, that I have seen testimony by here, say that the supply side tax cuts that we were all told 2, 3 years ago that were going to bring us all these revenues were a mirage, and that those tax cuts were not delivered. That is on the tax side.

On the expenditure side we have deficits in major part because military spending has declined so rapidly.

Fourth, a major factor in our trade deficit has been the U.S. failure to intervene on behalf of our exports by loosening the international banks' stranglehold on the Third World foreign exchange earnings. Chairman Gibbons, I applaud you for your raising this issue in a number of the earlier hearings. I think this is a serious issue, and the farms and factories, as you call them, have suffered at the hands of the way debt rescheduling has been done, and I will get into that in more detail later.

So those, I think, are the fundamental problems that require a change of policy. Those reflect themselves in what Chairman Volcker Tuesday called the proximate causes and he mentioned the dollar. Those mismanagements at the micro and macro level have affected the value of the dollar and that that, in turn, affects the way businesses see their competition.

Another proximate cause has been the slower growth abroad, but even there I would point out that the United States plays a unique role in the world economy. We are the biggest, most powerful economy around. We inflicted on the world huge increases in real interest rates 4 or 5 years ago. The rest of the world has had to live with those because while they do enjoy some improvement in their competitiveness from the rise in the dollar, they have resisted too dramatic a fall in their currencies because they did not want to increase inflation, particularly of oil. So they have kept their interest rates competitively high which meant higher real interest rates and slower economies, further aggravated by rising oil prices.

So, the fact that we are growing faster than other countries goes back to our high interest rate policies which have created such a vacuum for the world's available capital. Thus the growth differential is only a proximate cause, but the underlying cause has more to do with our monetary and fiscal policies.

Let me back up to the value of the dollar because I passed over a point I wanted to make there. The dollar is overvalued, according to anybody who looks carefully at the numbers. I realize that Treasury Secretary Regan says and I am quoting, "There is no external measure of what any currency is worth other than what the market is telling us it is worth." That, in my view, is a stockbroker's view of the world. You consider the dollar as a currency like an assset or a stock or a bond and don't worry about what the underlying effects are. For us, the dollar is a lot more important than any other asset's price. It affects our competitiveness and, in effect, if you say that we have a 30-percent overvaluation and that is what it is conservatively estimated as, that is the equivalent of a 30-percent tax on our exports; and just as importantly and there is too often neglected—it gives a multinational company looking about whether it is going to produce a 30-percent subsidy to produce outside of this country rather than here. Here I put as much stress on our monetary policy in the last few years as on our fiscal policy. I do not agree with the members of this subcommittee Tuesday who applauded Mr. Volcker for his efforts to preserve the value of the American dollar because it has cost us badly in international markets and it is affecting investment decisions today that will affect our jobs and our trade flows for years to come.

The issue of the debt servicing crisis in the Third World, which you have been raising often, has not gotten an adequate discussion from many of the witnesses.

I am appalled that, according to an article in Monday's Wall Street Journal, there is a split between the U.S. bankers' view and the European bankers' view about what to do about the rescheduling problem of Third World debt. It said that the U.S. banks generally are upset that the European banks want to be more lenient on the terms that they give because they are too concerned about exports. It is appalling that the United States is not more concerned about what has happened to our exports in the actions of the U.S. Government and the IMF. In overseeing debt reschedulings, they have neglected the effect on our exports.

Between 1981 and 1983, U.S. exports declined by $33 billion. Within manufacturing alone, that is where I want to emphasize our exports declined by $22 billion overall. But within our exports of manufactured goods to Latin America alone our exports declined by $15 billion. So 15 out of 22 was strictly manufactured exports to Latin America. We know this firsthand in our four industries. In fact, if you look at table 9 in the back, the auto industry's exports fell from $3.6 billion in 1981, this is column 5, to only $1.5 billion in 1983. Aircraft fell from $1.8 to $0.8 billion. Construction equipment from $1.5 to $0.3 billion. Agricultural machinery from $700 to $100 million. So far the four industries combined, 1981 had $7.6 billion at the bottom of column 5; 1983 had only $1.7 billion. A decline of two-thirds from roughly a $5 billion loss in our four exports to Latin America.

Put another way, the total drop in manufactured exports between 1981 and 1983 under column 3 was $21.8 billion. That is the total decline in manufactured exports. The $4.9 billion of that, almost a quarter of it, was our four industries loss of exports to Latin America. It was a very serious problem.

Again, let's look at what are the sources of that problem. It is too easy to blame, as the American public has been led to believe and the media often suggests, bad management in the Latin American countries or other Third World countries. In fact, the U.S. banks and other international banks are as much to blame as those countries are. The banks were the ones directly overseeing the loans. A lot of those loans were bad loans. They went to people to buy condominiums in the United States or Swiss bank accounts. They did not contribute to the productivity of those countries.

Even as the value of the external debts was growing rapidly, so were exports until 1980. The burden of those debts was not growing until we socked them with our mismanaged macropolicy and again, I emphasize monetary as well as fiscal policy. We gave them a high dollar, which meant it is much more expensive. They had to ship a lot more goods out to get the same foreign exchange, the same amount of dollars to pay the banks off. We gave them high interest rates. In 1978, before our monetarist policy kicked in, interest rates on Latin America's debt averaged 7.9 percent. They averaged 10.9 percent for 1983. Much of their debt now has varible interest rates. As the principal on other debt gets rolled over, interest rates are kicked up higher, as well. In addition, our mismanaged macropolicy slowed the world's growth, slowed their ability to export.

Something else gets lost in talk about the net flow of funds into the United States. The major change has been that the United States no longer sends the funds out. The gross level of funds coming into the United States has been relatively stable. It is the flow of funds out that has dried up. That gives us such a big net inflow of funds. It is our macropolicy, our high interest rates, our pressures on the banks to keep their funds here that has meant that they are no longer providing the funds to countries of the Third World, so that they can continue to finance their trade.

Chairman GIBBONS. I believe they dropped from $100-plus billion down to $14 or $15 billion or something like that?

Mr. PRICE. It is that order of magnitude, yes, sir.

Chairman GIBBONS. There wasn't anything left there to buy anything with. We dried up the credit market.

Mr. PRICE. That is right.

I think if you go back, in my view there are a lot of lessons to be learned from the experience of the thirties. In the thirties a number of Latin American countries did completely default on billions of dollars worth of debt. At that time as well they had this problem of capital drying up. You have to have capital in order to finance the trade going back and forth, in order to maintain the growth of the economy. It is fine to create credit if you have growth in the underlying economy to back it up. In fact, we should no more expect the Latin American countries as a whole or any given Latin American country to pay off its debt any more than we expect the U.S. Government to pay off its debt. The point is not to pay off the debt. The point is to maintain sufficient growth so that you can carry the burden of that debt and pay the debt service on it. The United States is not going to reduce its debt but it can grow enough to service the current debt and the same for the Latin American countries. If they can be allowed to grow, then they can carry the burden of that debt. But for the last 4 or 5 years, they have not been able to do that, and finally in 1982 a number of them collapsed in their ability to meet the scheduled payments.

The charts on page 11 are particularly instructive. The numbers come from a recent publication by the U.N. Economic Commission on Latin America. Through 1981 the Latin American countries were getting substantial capital inflows, as shown on chart B on page 11. In fact, those inflows were in excess of their net payments of interest, So they had new borrowings greater than their debt service, which allowed them to import more than they exported slightly. That took a turn in 1982. You can see that net capital inflow on chart B hit a peak of $38.1 billion and then it collapsed down to only $5.5 billion of new loans to Latin America last year. At the same time, their debt service continued to grow leaving the gap of $25 billion you see on chart C. The net transfer of resources as shown on chart C was positive up until 1981 and all of a sudden, the Latin American countries found themselves having to pay a lot more in debt service than they were getting back from the banks in new loans. And that, in turn, had to be taken out of their trade accounts. You can see what has happened to the trade surplus since 1981 in chart C. All of that trade surplus, if you look on chart D, was taken out of imports. Exports have declined slightly but imports have plummeted 40 percent. So U.S. exports to Latin America have suffered along with the rest of the world. It is not a matter of exchange rate. It is a matter of their simply not having the foreign exchange to buy from anywhere.

We have stated the problem and the chronology that led up to it, but then the question is what to do about it. People like you on trade subcommittees should talk more to the administration about having more sympathy with the European banks' position. We have got to let those economies reignite. At the top of page 11 the chart shows their real per capita income has fallen 13 percent in 1970 dollars, from $1,009 per capita down to $883. That per capita income may continue down even if they get some slight economic growth in the next few years because the population may increase faster.

It is very important for purposes for the United States, for those Latin American countries, and other Third World countries for them to restabilize and get back on the path of growth. They are not going to be able to do it with the myopic behavior of the banks in their rescheduling today. We have got to have a situation where they can move back to a trade balance.

Chairman GIBBONS. In your chart A why did their per capita income grow so fast between 1978 and 1980? Was that an anomaly or what? What made it shoot up so fast? It looked like it was growing steadily.

Mr. PRICE. No, table 8 has the numbers for a larger number of years. You can see that the fourth line, per capita gross national income was the place where I took those numbers.

Chairman GIBBONS. I got you.

Mr. PRICE. It grew in 1970 dollars to $1,009. So it grew rather substantially from 1975 to 1977 and in 1978 it tapered off and then it grew again rapidly. Most of Latin America grew quite rapidly as you can see in their growth rates, their per capita growth, the third line under growth rates on table 8. It was negative at 1975 when we had a world recession. Then it kicked back up to 2.5, 1.3, 4.6, 3.8 through 1980 and then you could see the big numbers of negatives since 1980.

Those are countries that had major expansions of their industrial production. They have had active economies through the seventies. Part of the reason they were able to do that is they were able to borrow on international markets. As shown on the second to the bottom line of table 11, the ratio of their debt to their exports was in the 200 percent range through 1980. The real dramatic change happened after 1980. So I don't think 1980 was an anomaly although you can have a blip because of statistical artifacts in any kind of statistics like this, when you are combining the statistics for 20-some odd countries, converting into dollars, and translating into 1970 dollars. The fact is through the seventies they were growing rapidly. They hit a peak in 1980 and they have been plummeting since 1980. And without a change in their external financial situation, I don't think there is any reason to expect them to go back up.

Chairman GIBBONS. There is not a high population growth?

Mr. PRICE. With or without high population growth you are not going to see a bottoming out of this without a change in the external financial conditions. The United States has to change its thinking about this to allow them to import more of the vital imports. Take our industries for an example. These countries need basic transportation, for which they need auto parts. They need farm equipment. They need construction equipment. They need aircraft and all those have been cut by two-thirds. They had been growing, depending on those kinds of imports until 2 years ago. All of a sudden they can't have them. That has got to have a negative effect on their economies. Capital goods imports for Latin America are as important as oil for this country. If all of a sudden we had a shutdown in imported oil, the economy of this country would be thrown for a loop. That is what happened with capital goods imports for Latin America.

If I can turn now to trade policy. Protectionism is a word that is often thrown around in American political discussion. People are castigated for being protectionists and the term is most often applied to the appeals of American industrial workers. However, in practice as we have faced problems in the international marketplace in recent years, our Government has been protecting American businesses. Unconditional protectionism is as American as apple pie. We see regular intervention on behalf of American businesses all the time. However, we have not had intervention in the international marketplace for the sake of helping American workers very often. In the case of the banking situation, the banks have been assisted regularly by the U.S. Government, whether through the Federal Reserve, the Treasury or the Eximbank's intervention. Those banks were not prepared for what happened in the international marketplace. They have made mistakes, things changed, and they wanted the Goverment to help them. They got protection.

What troubles me is not only did they get protection, but they have continued to have unseemly high profits and stock prices for an industry that has been in such desperate need of Government help.

If you go to the agricultural sector, we have also had regular and substantial intervention of a protectionist nature. Part of the reason that income levels in agriculture are at the lowest level in many, many years is because we no longer export our agricultural products in the same volumes and prices that we could a few years ago. We have quotas and income support programs for agribusiness. We channeled $19 billion of income support to them in fiscal 1983. The net income of agriculture in 1983 was $22.8 billion. Thus, roughly 80 percent of their net income came from the Government. That was a form of protection any way you look at it.

We think fair protection should also apply to industrial workers. We are not a country solely of consumers, but we are a country of breadwinners and taxpayers. If the international economy has dramatic changes that would disrupt our banking sector, our farming and manufacturing sector, those kinds of changes can cause distress to the overall economy. That kind of disruption leaves thousands unemployed, communities in disarray, and added strains to our Government's finances.

In our particular instance, we represent many workers making farm equipment. They are hurt by the fact that farm incomes have been hit so badly. It has helped us because the Government has stabilized the farming sector, but that is protection. And when it comes to industry, we have had intervention mostly for the sake of the companies and not for the sake of the workers involved. For example, in the last 3 years of auto relief the U.S. companies have had additional sales that they otherwise would not have had, but they have made little apparent effort to become more competitive in small car production here.

Likewise the steel industry has had intervention.

We think it is important, in considering how to change and apply our trade laws, that we take more into account what is happening to the state of workers in how the relief should be done. We should try to assist workers and not so much the companies, who are too often shifting to importing themselves or out of the industry as a whole.

Now if we turn to specific industries and see what are some of the problems there, I want to just make an aside. I had the opportunity to look at the testimony of the person from American Express who talks about the service sector. In my reading of the service sector data, it is important to distinguish two types of services.

One is the profits and royalties, repatriation of funds having to do with U.S. multinationals' activities abroad and services that have to do with U.S. value added, that is, exported real business services. When you separate those two out, you find entirely different numbers. Most of the big numbers have to do with things that don't have anything to do with jobs today in America. When you look at what does have to do with jobs today in America, business services, whether it is banking or insurance, accounting, and those sorts of things, the United States has very few exports and probably runs a deficit overall. We are not going to solve our trading problems by putting a lot of emphasis into the business services sector.

You will have later testimony on the textile/apparel industries, so I think I'll skip over that and move on to the auto trade deficit.

If you look at the chart on page 15, it depicts the relative importance of our trade deficit and shows that the auto deficit last year on an FAS basis was close to $20 million. That was equivalent to two-thirds of our $31 billion total manufacturing deficit in 1983.

Again, there is a lower number than other places because of FAS measurement. But that $20 billion deficit represents 500,000 lost jobs by the usual multiplier of 25,000 jobs per $1 billion.

Chairman GIBBONS. Is that auto deficit included in the manufactured goods deficit?

Mr. PRICE. Yes, it is.

Chairman GIBBONS. It is a part of the $31 billion?

Mr. PRICE. If you took the manufactured deficits excluding auto, you would have $11 billion in other manufactured goods. Again, this is on an FAS basis. The 31 becomes 38 on a CIF basis.

The administration and many in Congress have turned a blind eye to the auto's fast rising imports and the plans of U.S. companies to move offshore for small car production.

For example, recently Commerce Secretary Baldridge said that we should no longer think about getting restraints on auto imports from Japan because auto sales and profits are recovering. He and many other people tend to ignore the continuing dismal employment situation and future employment situation.

Auto employment is only halfway back to its 1979 level from its 1982 trough; 150,000 workers have been dislocated from the industry. Communities that depend on auto and its suppliers, like steel, rubber, glass, machine tools, continue to have double digit unemployment rates.

The United States is in the process of losing its capacity to produce small, fuel-efficient cars. Business Week had a cover story on this last month. Those cars comprise 40 percent of our market, and when fuel prices resume their inevitable upward rise, the small car share will get higher. U.S. companies are going about sourcing their small cars from Japan, Korea, Mexico, and Europe. As a result, we are going to lose hundreds of thousands of jobs.

When you think about losing small cars, consider the experience in 1979 when there was an oil price hike in the aftermath of the Iranian revolution. The U.S. industry had insufficient capacity for small car production, and auto employment suffered greatly.

We look to the future and see the possibility of not having any small cars. In 1979 we at least had the Chevette, the Pinto, the

Omni, and the Horizon. We are talking about not getting any of those replaced in the next few years. Without the ability to manufacture and assemble those small cars, we will be facing a worse calamity than we did in 1979 and 1980.

I'd like to turn now to this notion of foreign government targeting and what can be done about it.

Chairman GIBBONS. Let me ask you, why won't the American car manufacturers manufacture a small car here? Why won't they?

Mr. PRICE. Well, there are a number of reasons. The previous witnesses touched on them. The difference in the exchange rate is very important. They look at a grossly overvalued dollar and undervalued yen, planning where to put their investment. That is a strong incentive to not put it here.

You look at the difference in the tax structure. Again, there is a strong incentive not to put it here. Look at what Mexico and Korea are offering them and require of them. There again are strong incentives to put it there.

The United States doesn't have a policy that says it is important to have small car production here. All those other countries do.

But let's turn to the fact that those countries have a government policy on the auto industry. They are not unique. The Europeans have had a policy ever since World War II to build up their national champions to have a strong auto production base. The newly industrializing countries, Japan, and Canada, have all had active auto policies. What are we supposed to do about that? The United States doesn't have a policy. It is important whether we have an auto industry or not. Basically three approaches have been proposed.

One is your bill having to do with targeting. One is the Jones-Frenzel so-called reciprocity bill, and we think another route is the one that we propose in domestic content.

There has been a lot of talk recently about foreign government targeting, and microelectronics, and petrochemicals, but the foreign governments abroad are not doing anything in those two industries today that they haven't done in the past for their auto and their steel industries, and in many cases they continue to do for their auto and their steel industries.

So let's look at these different approaches. The so-called reciprocity legislation, H.R. 1571, says, "Let's give ourselves retaliatory authority. Their country is doing an industrial policy that is going to cause injury to us; we can bully them out of it by sufficient retaliation."

In fact, that authority as applied to goods trade has been in the U.S. laws since 1974. This particular bill, despite the common understanding of it, only changes our authority to help the U.S. multinationals. Even in services, the bill would effectively help the multinationals in that sector move more employment abroad, too. So you are talking about multinationals in this bill.

The notion is that we can change our thinking about 301 and do more retaliation, and that will clear up our problems. We think that that is not going to be particularly fruitful if it is legislated. The bill proposes a constant threat of retaliation against other governments for what they consider their own internal domestic policies.

When they think of industrial policy, they don't think first and foremost that they are hurting the United States; they think that they are helping themselves, and in many cases their policies, they think, have been successful. They think they are domestic, and they think they are successful.

So if we regularly come up to them and say, "We are going to retaliate if you don't stop doing something that is going to hurt us," then either one of two things is going to happen. Either we are seldom if ever going to do it, in which case it will become an empty threat; or we are going to do it so often that it will become a major source of trade friction, and other countries will start retaliating back against the United States.

Because their policies are so deeply ingrained and because they view them as so successful, they are not going to change very often if we threaten retaliation, and we are going to continue to be injured. Thus, the 301 route is not going to solve the problem that they have had policies for promoting industries that are causing us injury.

We turn now to your bill, H.R. 4784. You define targeting as—and I'm abbreviating but quoting—"coordinated actions bestowed on a specific enterprise, industry, or group, and the effect of which is to assist the beneficiary to becoming more competitive in the export of any class or kind of merchandise."

The bill goes on to give an illustrative but not exhaustive list of the Government targeting actions. When such targeting is found, the United States would charge a duty on imports of those industries to countervail against the targeted assistance.

It has been argued that foreigners cannot charge such duties on our exports because our Government assistance to industries have been too haphazard and not really coordinated.

However, if the United States did charge such duties against targeting often enough to make a perceptible change in our trade policy and, more particularly, to the health of our industries here at home, other governments would almost certainly start slapping on duties on our exports whether or not we insisted that our Government assistance remains totally haphazard and is not coordinated.

The other problem I have and the UAW has with this kind of approach is that if we set ourselves up for penalizing this kind of behavior of becoming more coordinated and less haphazard, we are setting up an incentive for ourselves never to do it.

We think that it is important for the U.S. Government to become more coordinated. If we set a standard that says you can slap huge duties on a country when they become coordinated, then we will have a disincentive ourselves to become more coordinated. For that reason, we think that this second alternative to deal with Government competition and its effect on industries is not the way to go.

Domestic auto content legislation is, we think, a preferable way to go as applied to the auto industry. This is an industry that is both multinational and has a limited number of competitors, but it is a remedy fashioned to deal with that auto problem which, as I repeat, is an industry that has been targeted around the world and targeted every bit as thoroughly as today we find in petrochemicals and microelectronics.

We don't object to the fact that those other countries have industrial policies to the extent that they benefited their own internal economies, but we think it is important for us to limit the injury that it causes to us. We think this is the appropriate way to go because it stabilizes employment here. It requires each major auto company to maintain a certain level based on its sales here.

Contrary to the popular understanding of this bill, as I recently read in the Washington Post and heard on national public radio, this does not require that every imported car have a certain percentage of American parts. It applies to a company as a whole, not to each car, and it applies to only the biggest companies. It doesn't apply to Volvo, BMW, and a lot of other smaller companies. It applies to the major sellers, all of whom have close to a billion dollars in sales in this market or more.

The auto industry directly and indirectly employs 2.5 million Americans. We project that, based on independent assumptions by Wall Street analysts of the industry and auto industry analysts in academe about imports of parts and vehicles by the U.S. companies is going to cost 650,000 jobs, a quarter of that 2.5 million jobs, in the next few years, if we don't take action to shore up the industry.

This content approach is superior to the yearly kinds of restraints we have had in the recent past. Under those restraints, there had been an implicit understanding that the U.S. companies would do something to become more competitive in small car production, but no requirement for them to do so. This bill would see those companies did continue to make small cars here, not only assemble them but manufacture them.

We at the UAW also feel aggrieved that the implicit promise has not been fulfilled. The UAW as a union went into negotiations early in 1982 with the expectation that the companies would make themselves more competitive with small cars. In the larger size cars, they have become more competitive and invested. But when it comes to the smaller size cars, their efforts and investment are quite lacking.

When it came to these year-at-a-time restraints, the auto companies looked at them and said, "We have lead times of 3 or 4 years. What is a year of restraint?" Particularly the last year of restraint during an election year was a complete political cover that did not fundamentally affect the decisions of the U.S. companies. We need an approach that does affect the investment and therefore jobs of the industry.

At the same time, this bill allows several years to phase in so that you could maintain competition in the market to the benefit of the American consumer. In the House passed bill, there would be a review in 1990 to see if further requirements would be appropriate.

In conclusion, I would want to state that to deal with our crisis in trade and manufactured goods, we need action on three levels. On one level, we need a more constructive trade policy to handle the problem of surging imports of specific sectors of industry; second, we need a reversal in our monetary and fiscal policies at the macrolevel; and, third, we need more attention to restore our exports and the imports of the Third World as we go about rescheduling the debt service payments.

Thank you, Mr. Chairman, for this opportunity to present our views on the trade deficit.

[The prepared statement follows:]

Statement of Lee Price, International Economist, International Union, United Automobile, Aerospace & Agricultural Implement Workers of America, UAW

SUMMARY

The U.S. faces a trade crisis. Since 1980, our trade balance has declined over $80 billion. In manufacturing alone, our trade balance has plummeted even more—over $90 billion. In real terms, our manufactured imports have risen 27 percent and our exports have fallen 24 percent—at a cost of 2.5 million jobs.

The wellsprings of the trade crisis consist of (1) the lack of a satisfactory policy to limit trade injury in specific sectors; (2) monetarist stringency that cranked up the dollar and kept it there; (3) profligate as well as inequitable fiscal deficits due primarily to the mirage of "supply-side" economics on taxes and the rapid build-up of military spending; and (4) the U.S. failure to intervene on behalf of our exports by loosening the international banks' stranglehold on Third World foreign exchange earnings.

The common explanations for our trade problems—the overvalued dollar, slow growth abroad, and debt servicing problems in the Third World—all largely reflect the voracious demand for the world's available credit created by monetary and fiscal policies here in the U.S.

The debt servicing crisis of many Third World countries has crippled their economies and living standards. It has also accounted for over half the $33 billion loss in U.S. exports between 1981 and 1983. The crisis derives from the credit crunch in the U.S. which raised their interest rates, made dollars needed for repayment more costly, weakened their export markets, and created a vacuum for new credit available to them. For the sake of Third World living standards and U.S. exports, we need a new approach to payments on the Third World's debts.

Unconditional "protection" in the international market is regularly provided for American business—bankers, agribusiness, conglomerates, and multinationals. In contrast, industrial workers represent one of the most exposed and least governmentally "protected" sectors of American society.

Two legislative initiatives in trade—H.R. 1571 (the so-called "reciprocity legislation") and H.R. 4784, the Trade Remedies Reform Act—both assume that the U.S. can eliminate potential injury to U.S. industries by transforming the industrial policies of other countries. However, other governments generally consider those policies as their domestic concern and as very successful. Thus, we must act to relieve injury by adopting policies within our own jurisdiction.

We need a trade policy that limits injury and promotes restructing in specific sectors, particularly on behalf of the workers in those industries.

For the auto sector, which presents our largest trade problem by far, domestic content legislation promises to stabilize production and employment here while encouraging competition to build a quality product to satisfy the American consumer.

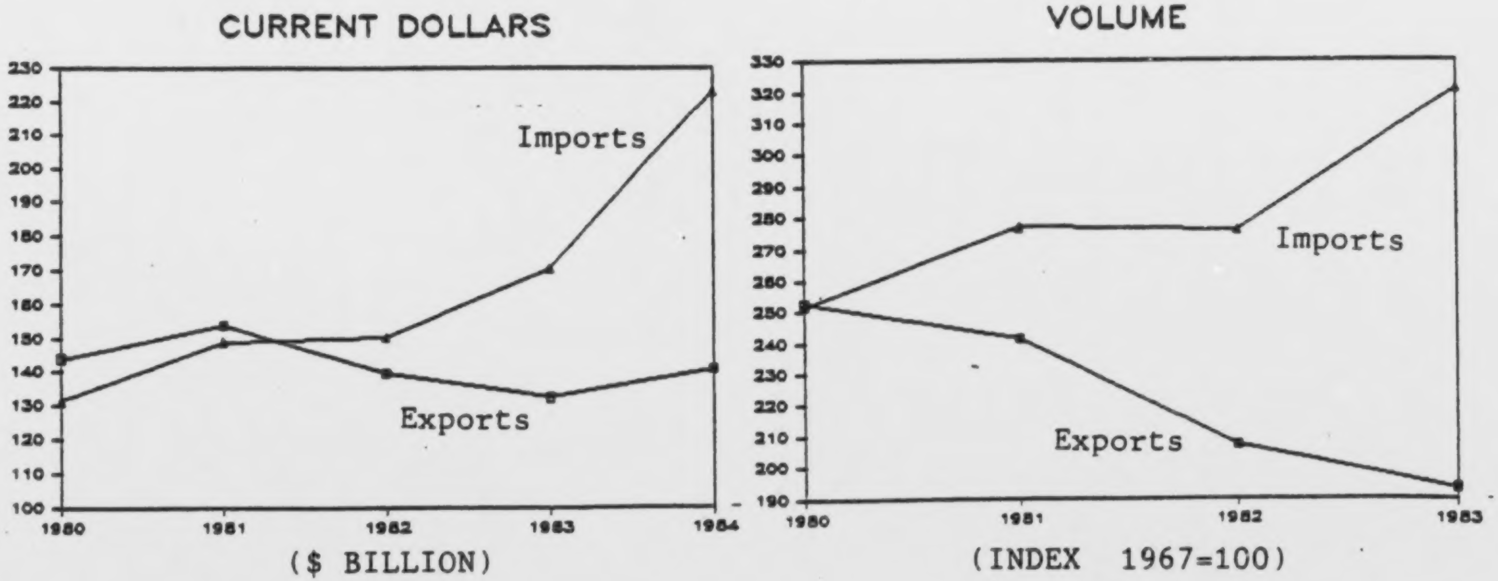
STATEMENT

Mr. Chairman, Members of the Subcommittee on Trade, thank you for this opportunity to testify on the current trade deficit on behalf of the UAW. The U.S. trade deficit has reached crisis proportions; it deserves your close attention.

The manufacturing sector has born the brunt of the deterioration in U.S. trade balances. Between 1980 and 1983, our manufactured imports climbed 27 percent while our manufactured exports sank 24 percent in real terms (Table I and chart below).

Our manufacturing trade balance receded from its high water mark of a $12 billion surplus in 1980 to an $82 billion deficit (annual rate) for the first two months of 1984. The downward swing of $94 billion since 1980 exceeds the $80 billion decline in the overall trade balance. More importantly, it represents 2½ million lost jobs.

US TRADE IN MANUFACTURED GOODS



RECENT TRADE EXPERIENCE OF FOUR UAW INDUSTRIES

The UAW represents most of the organized production workers in the auto, agricultural implement, and construction equipment industries and large proportion of those in the aerospace industry. All four of those industries have substantial trade—and have experienced very negative trends in recent years.

Taken together, the four main industries of UAW membership account for 30 percent of U.S. trade in manufacturing and provide a microcosm of the American manufacturing sector as a whole. One industry, auto, faces a flood of imports; the other three have lost substantial export and face added import penetration in specific product lines.

With its $17 billion in exports, the auto industry ranks as one of the nation's largest exporting industries. However, the industry's $42 billion in imports (Table 2) are exceeded only by oil.

For many years, the construction equipment industry exported 35 to 40 percent of its output and faced few imports. However, between 1981 and 1983 exports dropped over 60 percent—from $6.3 billion to only $2.4 billion (Table 3) and imports are climbing in specific products.

In farm machinery, exports have declined over a quarter but still remain above imports (Table 4). On the other hand, for agricultural tractors along, 1981's $270 million surplus turned into $224 million deficit for 1983 (Table 5). That $494 million swing results from an influx of imports from the U.S. companies' subsidiaries in Europe and a loss of exports to Canada and Latin America.

The aerospace industry continues to enjoy very large trade surpluses with 1983 exports of $16.1 billion and imports of only $3.4 billion. A sharp decline in exports of new civilian aircraft in recent years has been somewhat offset by continued growth in exports of replacement parts and military aircraft (Table 6).

Longer term trends in cars, farm tractors, and planes have some rough parallels. Because of the importance of mass production in all three industries, exports tend to come from variations on products designed for the local market. The typical car, tractor, and plane of Japan, Europe, and the U.S. reflect local conditions for fuel prices, urban and inter-urban driving, farm size, and flight distance and density. At least initially, the imports from Japan tend to be smaller and simpler, while imports from Europe fall into the medium and larger size ranges. As U.S. producers have shifted their production into larger, more sophisticated equipment, they have found a large foreign market for tractors and planes, but not cars.

SOURCES OF THE $120 BILLION TRADE PROBLEM

Our growing trade problems derive from mismanagement at both the micro- and macro-economic levels. At the micro level, we have a haphazard approach to the trade problems of specific industries—when we do anything about them at all. Too often, as our industries have run into trouble, we protest that other governments have implemented an effective policy for their industries but do not adopt a constructive policy of our own. As discussed below, the failrue of our micro management of trade problems will remain serious even if we resolve the macroeconomic sources of the trade problem.

At the macro level, we have had five years of excessively tight monetary policy at the Federal Reserve and three years of profiligate and inequitable Reaganomics. On the domestic front, both of these two hands have twisted the tourniquet on the flow of credit in our economy. Instead of real interest rates in the traditional 2 to 3 percent range, they have been running in the 6 to 7 percent range since 1980. Not since the Great Depression has the U.S. experienced such high level real interest rates and deep economic decline.[1] Unfortunately, these setbacks in the domestic economy have been compounded by trade developments.

The U.S. enjoys a privileged status because may other countries use the dollar as their currency for reserves and trade transactions. If any country other than the U.S. had mismanaged its macro policy as badly as the U.S. these last few years, it long ago would have seen the IMF hovering over every important internal economic decision by its government. The projected $80 billion in net borrowing from the world projected for the U.S. in 1984 represents 40 percent of our current export level and almost 3 percent of GNP.

A very misleading picture of our trade problems comes from separately measuring the effects of the rise in the dollar's exchange rate, weak export markets, and the debt crisis. As Chairman Volcker testified with respect to the dollar Tuesday, these represent "proximate causes" but not independent forces depressing our trade balance. He argued that our budget deficits are the underlying cause for the rise in the dollar. We believe his monetary policy in combination with the fiscal policy represent the underlying causes for three "proximate causes" for our trade problems: the high dollar, slower growth abroad, and the inability of many Third World countries to service their debts as scheduled. Moreover, if we can reform our macro policy, these proximate causes should shrink simultaneously.

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[1] Those who think that the recovery in the last year proves that we need not worry about high real interest rates should note that cyclical upturns punctuated the Depression.

In their breakdown of the additions to the trade deficit, most analysts neglect yet a fourth factor—declining competitiveness. Wholly apart from the dollar, the U.S. has become less competitive overall in the last three years. Yet, this has been masked by the large net inflows of capital that have offset the collapse in trade accounts and kept the dollar at its high level.

MISALIGNED EXCHANGE RATES: THE DOLLAR AND THE YEN

Badly misaligned exchange rates constitute the most important proximate cause of our $120 billion trade deficit. We should be particularly concerned about both the dollar and the yen. Since Japan represents the most serious competitor for most U.S. manufacturing industries, the relative value of the yen should be closely monitored.

The evidence suggests that the dollar is extremely overvalued relative to the rest of the world and the yen somewhat undervalued.[2] As recently as 1981, the U.S. and Japan had comparable current account surpluses of $4.6 billion and $4.8 billion respectively. However, for 1984 the OECD predicts that the U.S. will descend to an $81.75 billion current account deficit while Japan will climb to a $31.5 billion surplus.

The exchange rate of the dollar began to blast-off in the summer of 1980 as a result of stiff monetary policy, as Martin Feldstein noted in testimony on trade March 23. As high real interest rates attracted foreign funds, they bid up the price of the dollar. Further net inflows of capital have helped finance recent budget deficits running triple the previous annual record of $66 billion in 1976.

Once the dollar value began orbiting in the stratosphere, the Federal Reserve has not encouraged its descent for fear of heating up inflation. In this Subcommittee's hearing Tuesday, Chairman Volcker continued to show an overriding concern about inflation relative to our industry's competitiveness. While this myopic policy has kept the current price level below what it would otherwise have been, it has merely postponed the day of reckoning. When the dollar eventually comes down—as Mr. Volcker concedes it must, it will kick up inflation. By then, the economy will probably have become more sensitive to inflationary shocks and the boost to inflationary momentum from a declining dollar will exceed the drag on inflation from today's high dollar.

Secretary of the Treasury Donald Regan has counseled a policy of "benign neglect" toward the dollar and downplayed the significance of monetary stringency and massive budget deficits. Befitting the former head of Merrill Lynch, he expresses a "stockbroker's view" of the dollar as simply an asset like a stock or bond, "There is no external measure of what any currency is worth other than what the market is telling us it is worth."

The dollar is no ordinary asset—except perhaps for brokers and Treasury officials. Its relative value affects hundreds of billions of dollars in trade and investment decisions.

The post-1980 surge in the dollar relative to the currencies of our major trade competitors has been estimated in the range of 30 to 55 percent since 1980. The extent to which this rise overstates or understates the proper dollar value will remain in doubt until the capital inflows subside.

The rise in the value of the dollar since 1980, conservatively estimated at 30 percent, has had the same effect as taxing our exports by 30 percent and subsidizing our imports by 30 percent. Just as importantly, it gives a multinational company a 30 percent subsidy to produce abroad rather than here. For these reasons, we do not agree with those members of this Subcommittee who applauded Mr. Volcker Tuesday for his "efforts to preserve the value of the American dollar."

The U.S. has neglected its loss of competitiveness due to the dollar's rise for too long. Cranking the dollar back down requires both loosening monetary policy and equitably reducing the federal deficit by restoring taxes on corporations and the wealthy and reducing the Pentagon's expenditures. For the future, the Federal Reserve should explicitly target the dollar for a competitive exchange rate. That exchange rate should be the subject of Congressional hearings and public debate. The Federal Reserve should coordinate its action with the central banks of other key countries.[3]

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[2] John Williamson, "The Exchange Rate System," Policy Analysis No. 5, Institute for International Economics, September 1983; Shafiqul Islam, "Currency Misalignments: The Case of the Dollar and the Yen," FRBNY Quarterly Review, Winter 1983-84.

FASTER ECONOMIC GROWTH IN THE UNITED STATES THAN IN OTHER COUNTRIES

The U.S. deserves much of the blame for the fact that economic growth in other countries has slowed so that they are buying fewer of our exports. Those countries have had to raise their own interest rates to compete with our interest rates. If they did not, their exchange rates would fall rapidly as capital would flee their markets toward the U.S.[4] They do not want their exchange rate to fall too fast because it raises import prices—especially of oil.

As other countries have adjusted to higher interest rates and increased prices of oil, their economies have slowed or turned downward.

In effect, the U.S. has cursed the world with high interest rates these last five years and thereby slowed the entire world economy. We then broke into a recovery with the strongest Keynesian demand stimulus in post-war U.S. history. We could do that only because our role in the world makes us the "borrower of first resort."

According to the "locomotive theory" of world economic expansion, the U.S. recovery with its additional $70 billion in imports today compared to 1982 should have brought a boom to our trading partners.[5]

THE DEBT-SERVICING CRISIS IN THE THIRD WORLD

Over the last two years, a number of Third World countries have found themselves unable to meet their scheduled debt service payments. Both the U.S. banks and the U.S. government bear considerable responsibility for this debt-servicing crisis. While we agree that the countries with debt service problems need additional liquidity and that major defaults could damage the American financial system and our overall economy, we have two other concerns that have so far received short shrift from our government, the IMF, and the banks.

First, since the IMF and the International bankers will remain a powerful force in the internal politics of Brazil, Argentina, and the many other countries for years to come, we were concerned about actions that could nip the budding democratic institutions in those countries. For example, in the process of Brazil's democratic "opening," the dynamic new unions of Brazil have played a crucial political role in addition to their collective bargaining role. However, just as Poland has done during its debt crisis, the Brazilian government has attempted to crush key unions like the 100,000 member auto union.

The UAW actively supported language included in last fall's IMF legislation directing the U.S. Director to the IMF to consider carefully a country's treatment of democratic institutions, including trade unions. We hope that, in supervising the debt-servicing crisis, the IMF will preserve and promote democracy in Brazil, Argentina, and elsewhere.

Second, we have been disturbed by the short-sighted determination of the banks, backed by the IMF and our government, to extract maximum payments immediately. This has occurred at the expense of both of our own export industries and the economic and social viability of those countries. As they have been forced to pay exorbitant interest rates and rescheduling fees, they can devote less of their export earnings to vital imports from us. By undermining the continued ability of those countries to grow and export, the banks may be hastening the day of formal defaults.

The debt-servicing crisis has taken its toll both in the Third World and in the U.S. Third World living standards have suffered because vital imports of equipment and components have been curbed and government budgets have turned austere. For example, the U.N. Economic Commission on Latin America estimates that the per capita income for that region dropped 13 percent between 1980 and 1983 (Table 8 and Chart B on page 11). Moreover, most experts expect that trend to continue as population growth is predicted to exceed population growth for a number of years.

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[3] See, for example, Ronald I. McKinnon, "An International Standard for Monetary Stabilization," Institute for International Economics, March 1984.

[4] Of course, these other countries have generally welcomed some drop in their exchange rates relative to the dollar because it helps them compete better with the U.S.

[5] Of course, once the U.S. dollar declines and starts to bring down our trade deficits with it, the engines of the U.S. economy will be going in reverse as far as pulling along the railcars of other countries.

As Chairman Gibbons has emphasized in previous hearings, as the banks with the assistance of the IMF have taken widening claims on the foreign exchange earnings of the Third World, exports of American "farms and factories" have suffered. We in the UAW know this first hand. The combined exports by the four main industries of UAW membership fell 65 percent between 1981 and 1983, from $7.6 billion to $2.7 billion (Table 9).

The U.S. banks (along with their counterparts in Europe and Japan) bear primary responsibility for the fact that the rapid growth in Third World debt included many "bad loans." Although governments in developing countries did not begin closely monitoring the amount and use of foreign borrowing until the crisis hit, the U.S. government has not set a good example. The U.S. will borrow a net $80 billion this year but will not monitor where it is going.

Many of the loans to the Third World are considered "bad loans" because they did not contribute to new investment there but went instead for consumption and for personal investments in Swiss bank accounts and American condominiums. Since the international banks set the conditions for most of the loans, they had an ideal position to monitor the loans and prevent the funds from being squandered. The governments of debtor countries are justly disturbed by current pressures to guarantee debts in which they had never been involved.

The 1970's saw no debt servicing crisis because, although Third World debts were growing rapidly, their exports were growing apace. In fact, debt to export ratios of both the Third World and Latin America stood lower in 1980 than they had in several years (Table 11). Four interrelated developments since 1980 account for the inability of many Third World countries to make their debt service payments. All can be traced to the voracious U.S. credit markets.

(a) The rising value of the dollar made their largely dollar-denominated debt more difficult to repay because their export earnings have fallen in dollar terms: they must sell to other countries whose currencies now buy fewer dollars.

(b) Slow world growth has lowered the prices of their commodities and retarded their manufactured exports.

(c) As interest rates zoomed upward, so did Third World interest payments since most of their loans either have short terms or flexible interest rates. For example, the average rate of interest on Latin American debt rose from 7.9 percent in 1978 to 10.9 percent in 1983. That made their interest payments $33.9 billion last year rather than the $24.4 that would have applied without the increase in interest.

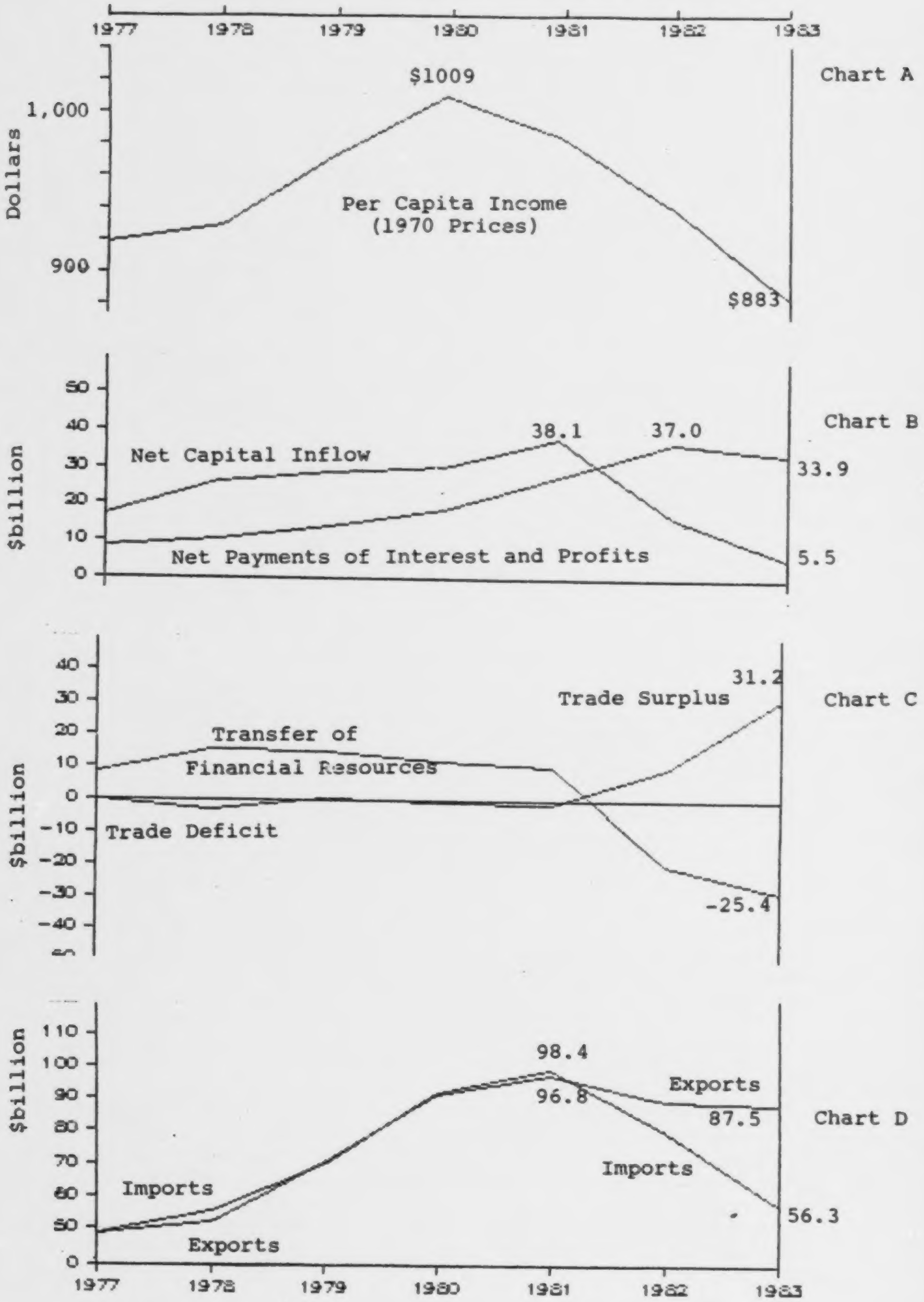
(d) With international capital surging into the U.S., international banks have stopped loaning new funds to most countries in the Third World. This has forced Third World countries to cut back drastically on imports—particularly of capital goods and components vital to the health of their manufacturing production, employment, and living standards.

What can be done to achieve better prospects for the standards of living in the Third World and for jobs here in the U.S.? First, the crisis in U.S. credit markets must be resolved to bring down real interest rates and the dollar while making more capital available to Third World borrowers.

Second, a new approach must be taken in debt service arrangements. We should no more expect the Third World to pay off its debt than we should the U.S. federal government to pay off its debt. Nonetheless, we can expect *both* types of debt to be managed in a more sustainable fashion than they have in recent years.

During the go-go 1970s, new capital inflow to the Third World exceeded debt service. This allowed Third World imports to exceed exports and, conversely, U.S. exports to them to exceed imports. In the last couple of years, these balances have flip-flopped as new capital has dried up and debt service costs have grown. The trends for Latin America shown on the next page provide a good illustration.

TRENDS IN LATIN AMERICA'S INCOME, TRADE AND PAYMENTS



Through 1981, Latin America's capital inflow far exceeded its debt service (Chart B on previous page). This provided additional foreign exchange equivalent to 15–25 percent of exports (Table 10, column 10). However, by last year the combination of a meager capital inflow and soaring debt service created a negative flow of finance to Latin America of $28.4 billion (Chart C). The new large deficit in the capital-plus-debt-service accounts is being offset in the trade account and particularly in imports (Chart D). Thus, Latin American imports tumbled 43 percent from $98.4 billion in 1981 to $56.3 billion in 1983. As a result, Latin America's goods imports amounted to just 63 percent of its exports last year (Table 8).

An upward trend in the living standards of the Third World (and in exports of U.S. equipment and components to support them) can resume only if Third World imports can rise toward the level of exports. That would, of course, require the banks to loosen their stranglehold on the foreign exchange of the Third World. That, in turn, cannot be expected to happen without pressure from the IMF and the U.S. government that apparently has not occurred to date. To get the banks to comply, monetary authorities in the industrial countries must have the necessary leverage and willingness to use it.

Future debt service arrangements should seek "balanced trade" by pursuing balance in the capital-plus-debt-service accounts. Trade balance could be resumed if: (a) All principal falling due is "rolled over"; and, (b) new capital inflow offsets the interest due. Ultimately, the real interest rate and the real growth of its exports are the key variables that will determine whether a debtor country can manage its debts. Under a "balanced trade" arrangement, debt would grow at a rate equal to the interest rate; a debtor country's capacity to pay would grow faster than its debt burden if the real growth in its exports exceeded the real interest rate.

If the major debtor countries can get substantial relief from their annual debt servicing burden, they can resume imports of critical equipment and parts. That would not only restore their internal growth and stability, but would benefit exporting industries here in the U.S.

PROTECTION NOW FOR BUSINESS BUT NOT LABOR

"Protectionism" is a dirty word in American political discussions and is most often applied to the appeals of American industrial workers. In practice, however, as problems have cropped up in the international marketplace, our government has done much to protect American businesses and very little to help American workers.

For the international bankers, the U.S. government (through the Federal Reserve, Treasury, and Ex-Im Bank) has consistently intervened to use its leverage and financies to assist the banks in negotiations with Mexico, Poland, Brazil, Argentina and elsewhere. The banks continue to have unseemly high profits and stock prices for an industry that has claimed such a desperate need for government protection.

In agriculture, net income has dropped to its lowest level since the Depression. In part, this is because we can no longer export our agricultural products in the same large volumes and at the same premium prices that we could a few years ago. Our federal government has sheltered the agribusiness corporations with a number of quotas and will income support programs—channeling $19 billion to them last year. That comprised over 80 percent agriculture's net income of $22.6 billion last year.

That logic that justifies protection of international bankers and agribusiness applies to industrial workers. Contrary to most trade analysts, we are not solely a country of consumers, but a country of breadwinners and taxpayers. Changes in the international economy that disrupt our banking, farming, and manufacturing sectors can cause great distress to our overall economy. Such disruption can leave many thousands unemployed, with communities in disarray and added strain on government finances.

When it comes to the trade problems faced by industrial workers, however, some argue that we only need appropriate monetary and fiscal policies. That's a little like recommending appropriate diet and exercise for health. For most people's health, diet and exercise should suffice—but that does not means we do nothing for the guy who needs his broken leg set. In the case of some industries, trade policy can provide timely and effective splint.

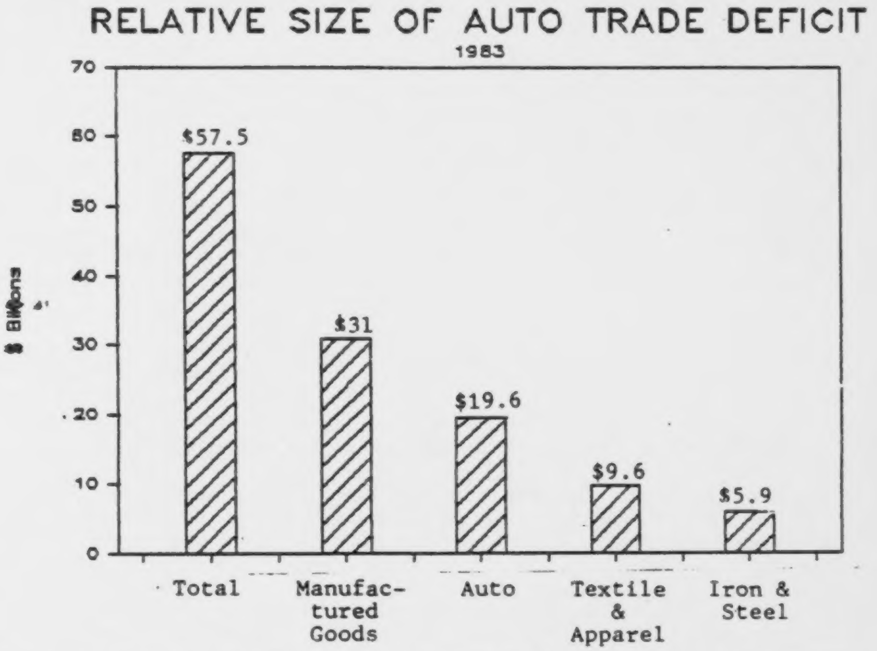
Even when industry protection is granted, it tends to help the companies far more than the workers. For example, during the last three years of auto relief, the U.S. companies made little apparent effort to become more competitive in small car production here but did make substantial new arrangements to import small cars. Likewise, the steel companies have moved into other industries with the added resources from several periods of import relief.

In determining whether injury is occurring and how best to fashion relief, our trade remedy laws and application should be reformed to put more emphasis on workers' employment and less on whether companies are profitable. Too often the protected companies simply shift to importing themselves or they diversify out of the industry to the detriment of their workers.

MAJOR PROBLEMS IN SPECIFIC INDUSTRY SECTORS

The U.S. faces major trade problems in specific industries. For example, in steel, we had a $5.9 billion deficit last year (Table 2). Since every billion dollars represents about 25,000 jobs, that $5.9 billion steel deficit represented 150,000 jobs.

In textiles and apparel combined, we had a $9.6 billion deficit. The Reagan Administration has made a commitment to prevent the growth of our textile and apparel imports from exceeding the rate of growth of our domestic market—which would keep the import share constant. On that basis, the Administration renegotiated arrangements with many countries last year because imports from them began to rise faster than our market.


RELATIVE SIZE OF AUTO TRADE DEFICIT
1983

Note: These deficits ran lower than others used in this statement. For purposes of comparability, imports had to be calculated on the lower f.a.s. basis.

As the chart above depicts, America's biggest single trade problem comes in the auto industry. Our $19.6 billion deficit (excluding Canada) last year represents 500,000 jobs. We ran a $14.7 billion deficit with Japan, a $6.1 billion deficit with Europe, and a $0.3 billion deficit with Latin America. (Table 12).

The auto deficit is growing rapidly. Between 1981 and 1983, our auto trade deficit leaped from $11.4 billion to $19.6 billion (excluding Canada). The biggest factor in that $8.2 billion swing was Latin America. There we had a $2 billion loss in exports and a $1 billion increase in imports. Meanwhile, we saw $2 billion increases in imports from both Japan and Europe (Table 12).

This Administration and many in Congress have turned a blind eye both to auto's fast rising imports and the U.S. companies' plans to move offshore for small car production. For example, Commerce Secretary Baldrige recently said that we should no longer seek restraints on auto imports from Japan because auto sales and profits are recovering. He said nothing about the dismal employment situation. Employment in auto is barely halfway back to its 1978 level from the 1982 trough: 130,000 workers have been dislocated from the industry. Communities that depend on auto and its suppliers (like steel, rubber, glass, and machine tools) continue to have double digit unemployment rates.

The U.S. is fast losing its capacity to produce small, fuel efficient cars as Business Week described in a cover story last month. Those cars comprise 40 percent of our market, and when fuel prices resume their inevitable upward rise, the small car share will be even higher. As the U.S. companies go to Japan, Korea, Mexico, and Europe to import their small cars, we will lose hundreds of thousands more jobs.

At the same time, we see the war between Iran and Iraq heating up. Back in 1979, when the Iranian revolution cut oil supplies, gas prices soared and the U.S. auto industry suffered badly from its insufficient capacity for small, fuel-efficient cars. Unless we act now to assure that those companies continue to manufacture and assemble those cars here, any future disruption of Middle East oil will bring an even worse calamity than that which occurred after 1979.

The UAW firmly believes that enactment of domestic auto content legislation offers the best way to prevent continued high unemployment in the auto and related industries, to assure capacity to manufacture small, fuel-efficient cars, and to maintain competition for the consumer. This legislation is discussed at greater length below.

COPING WITH INDUSTRIAL POLICIES ABROAD THAT INJURE UNITED STATES

Though seldom trade-specific, the industrial policies of other governments increasingly affect the health and competitiveness of our own industries. Three pieces of legislation now before Congress provide very different approaches for addressing that kind of problem. Members of this Subcommittee have introduced two pieces of legislation that assume that the U.S. can successfully transform the internal policies of other countries to eliminate injury to the competing U.S. industry.

A third piece of legislation turns attention to what can be done within our jurisdiction to relieve injury while promoting competition: the domestic auto content legislation. The auto industry has received—and continues to receive—as much "targeted" assistance from the other industrial and newly industrialized countries as the much-discussed targeting of the microelectronics and petrochemical industries today.

H.R. 1571, the so-called "reciprocity" legislation, takes the most provocative approach. It calls for the U.S. to take retaliatory measures against other countries when they take actions considered "unreasonable." The term "unreasonable" is left undefined. Contrary to the widespread belief about the bill, it actually adds no significant new authority for goods trade but emphasizes additional assistance for U.S. multinationals to invest abroad.

This legislation cannot begin to cope with our critical international trade problems. In the first place, helping our multinationals export even more jobs abroad will only aggravate our trade problems. And secondly, the constant threat of retaliation against the domestic policies of other countries will soon become an empty threat if we regularly refrain from retaliation; or it will provide a new source of trade friction because we do retaliate often.

An effort to change foreign governments' economic policies also provides the focus of H.R. 4784, the proposed Trade Remedies Reform Act introduced by the Chairman of this Subcommittee. It directs the Commerce Department to assess the value of so-called "targeting" defined as "coordinated actions * * * bestowed on * * * a specific enterprise, industry, or group * * * and the effect of which is to assist the beneficiary to become more competitive in the export of any class or kind of merchandise."

An illustrative, but not exhaustive, list of government "targeting" actions is provided.[6] When such "targeting" is found, the U.S. would charge a duty on imports from those industries to countervail against the targeted assistance. It is argued that foreigners cannot charge such duties on our exports because our government's assistance to industries has been haphazard rather than coordinated. However, if the U.S. did charge such duties against targeting often enough to make a perceptible change in our trade policy, other governments would almost certainly start slapping on duties on our exports—even if we insisted that our government assistance remains totally haphazard. Furthermore, we should not be setting ourselves up for penalties on our exports if we should ever wise up and become less haphazard in assisting our industries.

A key element of the original bill was an attempt to prevent settlements of disputes over government subsidized imports by quotas rather than additional duties.

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[6] Curiously, the list indicates that domestic content requirements can promote export competitiveness, contrary to arguments made against H.R. 1234 by some sponsors of H.R. 4784.

As a practical matter, that sometimes offers the most amicable route to resolving such conflicts. Because quotas permit more stability for trade than high additional duties, they have been welcomed by governments and industries on both sides of the disputes.

DOMESTIC AUTO CONTENT LEGISLATION

To cope with the U.S. injury from the targeting of foreign industrial policies, we believe attention must be turned toward what we can do here at home. H.R. 1234, the Fair Practices in Automotive Products Act or domestic auto content legislation, offers a good example of that approach as applied to a specific industry which has a limited number of competitors but is already organized on a multinational basis.

The auto industry has played a prominent part in the industrialization schemes of Europe, Canada, Japan, and the newly industrializing countries. Contrary to the belief of the Chairman expressed on the House floor debate on H.R. 1234 in November 1983, an ITC study completed the prior month (on a request from this Subcommittee) documented the fact that Japan provided targeted assistance to its auto industry.[7] Such targeting can be shown for every other country that now has substantial automotive exports to the U.S.

Nothing like "free trade" occurs in the auto industry around the world. Over 30 countries have local content laws. The major European countries have kept the Japanese share to an average of 7 percent of their market, compared to the 20 percent share here. They have, in effect, told the Jpanaese companies that a further increase in their share in Europe will require substantial investments in Europe.

Industrial policies to assist the auto industry have generally succeeded around the world. As a result, U.S. efforts to convince other countries to stop assisting their auto industries will prove futile. That still leaves us with the problem of what to do about the fact that our industry is rapidly being displaced because we lack an appropriate policy. While the UAW welcomes the fact that a healthy auto industry has contributed to the prosperity of workers in many countries, we believe that our government has responsibility to prevent the policies abroad from spilling over and injuring us.

The domestic auto content legislation puts its emphasis on straightening out our domestic policy and industry, not those abroad. It stabilizes U.S. auto-related employment by requiring each major auto company to maintain a certain level of production and purchases here based on its sales here.[8] To assure continued competition to meet the demands of the American consumer, the requirements phase in over 4 years. The House-passed version calls for a review in 1990 to determine whether conditions warrant an extension of content requirements.

The auto industry directly and indirectly employs 2½ million Americans. At least 650,000 of those jobs will be lost if we do not act soon to shore up the industry. Those jobs will be displaced by imports brought in by the U.S. companies as well as by foreign-based companies. For example, although GM now manufactures and supplies all its small cars here, it has commitments to import half a million small cars from Japan and Korea in the next few years. That's more small cars than GM currently sells here.

GM is not alone in making a big turn toward imported vehicles. Ford plans new imports in coming years of at least 160,000 small cars from Mexico and Europe. Chrysler is also known to be considering a major hike in its imports.

The content approach is far superior to the year-at-a-time restraints we have had on Japanese cars. When the UAW rengotiated its contract early in 1982 and as the U.S. government obtained a series of export limitations from Japan, we expected that the U.S. companies would put the additions resources into making more competitive small cars here. While the limits have permitted the companies additional sales and huge profits, there is little eidence that they have made themselves more competitive in small car production here.

Indeed, since lead times for projects in the industry far exceed one year, the U.S. companies have assumed the restraints would end soon and have proceeded with plans for the massive new imports. Content legislation would rearrange the auto giants' plans so that the U.S. companies would continue to produce small, fuel efficient cars here.

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[7] International Trade Commission, "Foreign Industrial Targeting and Its Effects on U.S. Industries, Phase I: Japan," Publication 1437, October 1983, pages 129–131.

[8] Contrary to widespread misperception, the legislation does not "require a certain percentage of American parts in every imported car." The requirements apply only to the major companies and permit cars to be imported without American parts.

The content approach includes not only cars but trucks and parts, where we also face grave import problems (Table 13). The content legislation also encompasses auto trade with all countries, not Japan alone (Table 14).

In addition, content legislation would lay the groundrules for renewed competition not just between domestic and foreign auto companies, but between the foreign companies themselves. By assigning quotas to each Japanese company, the Japanese restraints have reduced competition between the Japanese companies.

Thus, enactment of content legislation would finally give the U.S. an auto policy to offset the active auto policies abroad. It would maintain employment and production here while encouraging competition to build a quality product to satisfy the American consumer. Finally, other governments would accept such a clear statement of U.S. auto policy much better than retaliatory efforts to force them to change their own auto policies.

Of course, until content legislation gets implemented, continued restraints against a flood of injurious imports are essential. Those restraints should be designed to preserve U.S. manufacture of small cars and to promote investment here by foreign companies for the sake of competition and jobs.

CONCLUSION

Our growing trade crisis, particularly in the manufacturing sector, calls for action on three levels: (1) a more constructive trade policy to handle the problem of surging imports in specific sectors at the domestic microeconomic level; (2) a fundamental reversal in our monetary and fiscal policy at the domestic macroeconomic level; and (3) more attention to restoring vital imports to the Third World in the rescheduling of debt service payments at the international level.

Mr. Chairman, we appreciate this opportunity to present our perspective on our trade problems and what can be done to address them.

TABLE 1

Trends in U. S. Trade
($billion or 1967 = 100)

	1980	1981	1982	1983	Change 1980-83		1984*
					$	%	
Total Goods							
Exports	220.6	233.7	212.2	200.5	-20.1	-9	213.2
Imports, c.i.f.	257.0	273.4	254.9	269.9	+12.9	+5	330.6
Balance	-36.4	-39.7	-42.7	-69.4	-33.0		117.4
Export Volume	244.8	273.4	213.2	198.5		-19	—
Import Volume	208.9	210.7	200.2	220.3		+5	—
Manufactured Goods							
Exports	144.0	154.3	139.7	132.4	-11.6	-8	140.8
Imports, c.i.f.	131.5	149.0	150.3	170.6	+39.1	+30	223.0
Balance	12.5	5.3	10.5	-38.2	-50.7		-82.1
Export Volume	252.7	241.6	207.1	193.3		-24	—
Import Volume	252.0	277.2	276.2	321.0		+27	—

*First two months times 6.

Source: Department of Commerce, International Trade Administration, International Economic Indicators, and "Advance report on U.S. Merchandise Trade," March 29, 1984.

Note: Due to rounding, figures may not add or subtract as shown.

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TABLE 2

Comparison of 1983 Trade Deficits in Specific Industries
($ billion)

	Exports	Imports[1]	Balance
Total	200.5	258.0	-57.5
Manufactured Goods[2]	132.4	163.4	-31.0
Automotive Products[3]	4.6	24.2	-19.6
Textiles[2]	2.4	3.2	-0.9
Apparel[2]	0.8	9.6	-8.8
Textiles & Apparel	3.2	12.8	-9.6
Iron&Steel	1.5	7.4	-5.9
Machine Tools[2]	1.1	1.5	-0.4
Footwear[2]	n.a	4.0	

[1] Customs value basis for purposes of comparability
[2] Schedules A and E
[3] "End-use" commodity category, excluding Canada

Source: Department of Commerce, Bureau of the Census, FT990, Highlights of U. S. Export and Import Trade.

Note: Due to rounding, figures may not add or subtract as shown

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TABLE 3A

Construction Machinery
($billion)

	1979	1980	1981	1982*	1983*
Production Workers (000)	125.7	111.7	101.1	67.9	51.5
Total Employment (000)	175.2	159.3	145.9	110.8	84.0
Value of Shipments	15.2	14.9	15.6	9.4	8.9
Exports	4.5	5.7	6.3	4.0	2.4
Imports	0.7	0.7	0.9	0.8	0.6
Balance	3.8	5.0	5.4	3.7	1.8
Exports/Shipments (%)	35.1	38.6	40.5	42.4	29.2
Imports/New Supply (%)	4.8	4.7	5.8	7.7	6.1

* estimate.

Source: Department of Commerce, Bureau of Industrial Economics.

TABLE 3B

Mechanical Shovels, Coal-cutters, Excavators, Scrapers, Bulldozers, and Excavating and Levelling Machines

	1979	1980	1981	1982	1983
Exports	4.0	5.5	6.9	6.4	4.0
Imports	0.6	0.6	0.8	0.7	0.6
Balance	3.4	4.9	5.9	5.7	3.4

Source: International Trade Commission

Note: Due to rounding, figures may not add or subtract as shown.

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TABLE 4A

Farm Machinery
($billion)

	1979	1980	1981	1982*	1983*
Production Workers (000)	104.1	92.5	87.8	73.5	62.6
Total Employment (000)	140.3	125.1	125.0	109.4	95.8
Value of Shipments	12.0	11.3	13.0	9.8	9.3
Exports	2.2	2.6	2.9	2.4	2.1
Imports	1.9	1.8	1.5	1.2	1.4
Balance	0.3	0.8	1.4	1.2	0.7
Exports/Shipments (%)	18.2	23.2	22.6	24.3	22.6
Imports/New Supply (%)	13.5	13.5	10.6	10.8	12.3

* estimate.

Source: Department of Commerce, Bureau of Industrial Economics.

TABLE 4B

Exports	1.9	2.1	2.5	1.9	1.4
Imports	1.9	1.8	1.6	1.4	1.4
Balance	0.0	0.3	0.9	0.5	0.1

Source: International Trade Commission

Note: Due to rounding, figures may not add or subtract as shown

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TABLE 5

Agricultural Tractors and Parts
(\$ Million)

		1979	1980	1981	1982	1983	Change 81-83
Total	Exports	902	1,061	1,205	934	709	
	Imports	1,163	1,019	935	736	933	
	Balance	-261	42	270	198	-224	-494
Canada	Exports	443	444	644	452	404	
	Imports	234	201	219	170	182	
	Balance	209	243	425	282	222	
Japan	Exports	5	3	4	3	3	
	Imports	278	188	200	182	214	
	Balance	-273	-185	-196	-179	-211	
Germany	Exports	30	34	23	36	25	
	Imports	191	202	152	132	216	
	Balance	-161	-168	-129	-96	-191	
U.K.	Exports	29	29	30	29	30	
	Imports	195	195	138	77	149	
	Balance	-166	-166	-108	-48	-119	
France	Exports	29	35	28	28	27	
	Imports	53	35	30	16	25	
	Balance	-24	0	-2	12	2	
Mexico	Exports	95	138	76	41	16	
	Imports	5	3	2	7	13	
	Balance	90	135	74	34	3	

Source. International Trade Commission.

Note: Due to rounding, figures may not add or subtract as shown

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TABLE 6

AEROSPACE
($billion)

		1980	1981	1982	1983*	1984**
Aerospace Vehicles &Equip.	Exports	15.6	17.8	15.6	16.1	16.3
	Imports	3.2	4.3	4.2	3.4	4.7
	Balance	12.4	13.5	11.4	12.7	11.6
Civil Aircraft	Exports	8.4	8.6	4.8	6.2	4.7
	Imports	1.0	1.3	1.3	0.9	1.1
	Balance	7.4	7.3	3.5	5.3	3.6
Military Aircraft	Exports	0.9	1.7	2.4	2.1	2.6
	Imports	.003	.04	.03	.03	.05
	Balance	0.9	1.7	2.4	2.1	2.6
Aircraft Engines &Parts	Exports	1.9	2.3	2.5	2.8	2.6
	Imports	1.1	1.5	1.3	1.1	1.0
	Balance	0.8	0.8	1.2	1.7	1.6
Aircraft Parts & Accessories	Exports	3.4	4.2	4.3	4.5	4.7
	Imports	1.1	1.4	1.6	2.1	2.5
	Balance	2.3	2.8	2.7	2.4	2.2

* projection made in late 1983
** forecast

Source: Department of Commerce, Bureau of Industrial Economics, U.S. Industrial Outlook, 1984, with subsequent revision by authors.

Note: Due to rounding, figures may not add or subtract as shown.

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TABLE 7A

Complete Civilian Aircraft
($billion)

	1980	1981	1982	1983
Shipments	13.1	13.2	8.6	10.9
Exports	8.4	8.6	4.8	6.2
Imports	1.0	1.3	1.3	0.9
Balance	7.4	7.3	3.5	5.3

Source: Department of Commerce, Bureau of Industrial Economics.

TABLE 7B

Civilian Aircraft, Engines, and Parts
($billion)

	1980	1981	1982	1983
Exports	14.1	13.5	9.7	10.7
Imports	3.0	3.7	3.4	2.9
Balance	11.1	9.8	6.3	7.8

Source: Department of Commerce, Bureau of Census, FT 990, Highlights of U.S. Export and Import Trade.

TABLE 7C

Articles Covered by the Civil Aircraft Agreement
($billion)

	1980	1981	1982	1983
Exports	13.8	14.1	9.4	10.3
Imports	2.9	3.7	3.4	3.0
Balance	10.9	10.4	6.0	7.3

Source: International Trade Commission

TABLE 7D

Employment in Aircraft
(thousands)

Prod. Wkr.	167.0	156.5	135.6	122.0
Total	294.0	301.1	279.9	263.2

Source: Department of Commerce Bureau of Industrial Economisc.
Note: Due to rounding, figures may not add or subtract as shown.

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TABLE 8

LATIN AMERICA: MAIN ECONOMIC INDICATORS a/

	1975	1977	1978	1979	1980	1981	1982	1983b/
Gross domestic product at market prices (billions of dollars at 1970 prices)	263	292	305	326	345	350	347	335
Population (millions)	303	318	326	336	343	351	359	369
Per capita gross domestic product (dollars at 1970 prices)	868	916	936	974	1 007	997	965	911
Per capita gross national income (dollars at 1970 prices)	867	918	929	972	1 009	985	938	883
				Growth rates				
Gross domestic product	3.7	5.0	4.7	6.6	5.9	1.5	-1.0	-3.3
Per capita gross domestic product	1.2	2.4	2.2	4.0	3.4	-0.9	-3.3	-5.6
Per capita gross national income	-0.3	2.5	1.3	4.6	3.8	-2.4	-4.8	-5.9
Consumer prices c/	57.8	40.0	39.0	54.1	52.8	60.8	85.6	132.9
Terms of trade (goods)	-14.0	6.0	-10.9	4.4	4.2	-7.3	-7.0	-7.2
Current value of exports of goods	-7.1	18.9	7.5	34.3	30.1	7.0	-8.5	-1.3
Current value of imports of goods	7.0	14.8	13.8	25.8	32.3	7.6	-19.9	-28.7
				Billions of dollars				
Exports of goods	35.0	48.2	51.8	69.6	90.5	96.8	88.6	87.5
Imports of goods	40.4	48.3	55.0	69.1	91.5	98.4	78.9	56.3
Trade balance (goods)	-5.4	-0.1	-3.2	0.5	-1.0	-1.6	9.7	31.2
Net payments of profits and interest	5.7	8.5	10.5	14.1	18.5	28.0	37.0	33.9
Balance on current account d/	-13.7	-11.7	-18.3	-19.6	-27.7	-40.4	-36.4	-8.5
Net capital movements e/	14.7	17.3	26.3	29.0	30.2	38.1	16.8	5.5
Global balance f/	0.8	5.6	8.1	9.4	2.2	-2.3	-19.8	-3.0
Gross global external debt g/	89	105	133	166	205	259	290	310

Source: ECLA, on the basis of official figures.

a/ The figures for the product, population and income relate to the following countries: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela. The consumer price figures refer to all the above countries, plus Barbados, Guyana, Jamaica and Trinidad and Tobago (with the exception of Guyana in 1982 and of Guyana and Haiti in 1983). The data for the external sector refer to all the countries listed other than Jamaica, except in the case of the figures for the external debt, which also exclude Barbados and Trinidad and Tobago.

b/ Preliminary estimates, subject to revision.

c/ Variation from December to December.

d/ Includes net unrequited private transfer payments.

e/ Includes long- and short-term capital, unrequited official transfer payments, and errors and omissions.

f/ Corresponds to the variation in international reserves (with the opposite sign) plus counterpart entries.

g/ 1975-1980: Includes public and State-guaranteed private external debt plus the long- and short-term non-guaranteed debt with financial institutions reporting to the Bank for International Settlements. Excludes both guaranteed and non-guaranteed debts with other commercial banks, as well as suppliers' credit without State guarantees. The 1981-1983 period includes official estimates of the total external debt; the figures therefore have a broader coverage and cannot, in a strict sense, be compared with those of the preceding period.

Source: U.N. Economic Commission for Latin America, "Adjustment Policies and Renegotiation of the External Debt," February 22, 1984.

TABLE 9

Importance of Loss in U. S. Exports to Latin America ($billion)

	Exports to World				Exports to Lat.Am.				Importance Lat.Amer.	
			Loss				Loss			
	1981	1983	1981-83		1981	1983	1981-83		1981 Exports	Loss 81-83
			$	%						
	(1)	(2)	(3) 1-2	(4) 3/1	(5)	(6)	(7) 5-6	(8) 7/5	(9) 5/1	(10) 7/3
Total	233.7	200.5	-33.2	-14	39.0	22.6	-16.3	-42	17	49
Manufactured Goods	154.3	132.5	-21.8	-14	29.7	15.2	-14.5	-49	19	67
Machinery & Transp. Equipment	95.7	82.6	-13.2	-14	17.8	8.2	-9.6	-54	19	73
Auto	7.9	4.6	-3.3	-42	3.6	1.5	-2.1	-54	45	65
Civilian Aircraft	13.5	10.7	-2.8	-21	1.8	0.8	-1.0	-57	13	37
Construction Equipment	6.3	2.4	-3.9	-62	1.5	0.3	-1.2	-79	24	31
Agricultural Machinery	3.5	1.6	-1.9	-54	0.7	0.1	-0.6	-86	19	29
Total "UAW 4"	31.2	19.3	-11.9	-38	7.6	2.7	-4.9	-65	24	41

Source: Department of Commerce, Bureau of Census, FT 990 Highlights of U.S. Export and Import Trade.

Note: Due to rounding, figures may not add or subtract as shown.

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TABLE 10

LATIN AMERICA: NET INFLOW OF CAPITAL AND TRANSFERS OF RESOURCES

(Billions of dollars and percentages)

	Net effective capital inflow a/	Unrecorded transactions b/	Net capital inflow	2/1	Net payments of profits and interest	Transfer of resources		Exports of goods and services	6/8	7/8	Real transfer of resources c/	
	(1)	(2)	(3) (1+2)	(4)	(5)	(6) (1-5)	(7) (3-5)	(8)	(9)	(10)	(11)	(12)
1970	4.1	0.1	4.2	0.9	3.0	1.1	1.2	17.9	6.3	6.7	1.2	1.2
1971	5.2	-0.1	5.1	-2.3	3.2	2.0	1.9	18.8	10.3	9.7	1.8	1.7
1972	5.9	1.3	7.2	22.9	3.3	2.6	3.9	21.8	11.9	18.1	2.3	3.5
1973	8.8	-0.7	8.1	-7.5	4.4	4.4	3.7	30.3	14.3	12.1	3.4	2.9
1974	13.3	-1.7	11.6	-13.1	5.3	8.0	6.3	46.0	17.5	13.7	4.7	3.7
1975	16.4	-1.7	14.7	-10.3	5.7	10.7	9.0	43.7	24.3	20.4	5.7	4.9
1976	18.9	-0.7	18.2	-3.6	7.0	11.9	11.2	50.0	23.9	22.5	6.2	5.9
1977	15.8	1.5	17.3	9.6	8.5	7.3	8.8	58.7	12.3	15.0	3.6	4.3
1978	24.6	1.7	26.3	7.4	10.5	14.1	15.8	64.5	22.0	24.6	6.5	7.3
1979	27.4	1.6	29.0	5.8	14.1	13.3	14.9	85.8	15.5	17.4	5.4	6.0
1980	35.9	-5.7	30.2	-16.1	18.5	17.4	11.7	110.9	15.6	10.5	6.1	6.1
1981	48.8	-10.7	38.1	-21.8	28.0	20.8	10.1	119.6	17.4	8.5	6.8	3.3
1982	26.9	-10.1	16.8	-37.5	37.0	-10.1	-20.2	109.9	-9.2	-18.3	-3.2	-6.3
1983 d/	12.0	-6.5	5.5	-54.1	33.9	-21.9	-28.4	105.0	-21.0	-27.0	-7.7	-10.0

Source: 1970-1981, International Monetary Fund, Balance of Payments Yearbook; 1982-1983, ECLA, on the basis of official data.

a/ Equals net inflow of capital less unrecorded transactions.
b/ Corresponds to the "errors and omissions" entry of the balance of payments.
c/ The values shown in columns (6) and (7) are deflated by the index of the unit value of Latin American imports of goods and services (1970 = 100).
d/ Preliminary figures.

Source: U.N. Economic Commission for Latin America, "Adjustment Policies and Renegotiation of the External Debt," February 22, 1984.

TABLE 11

Trends in Third World Debt

	1977	1978	1979	1980	1981	1982	1983
Non-Oil Developing Countries							
Total debt outstanding	278.5	336.3	391.1	467.6	550.8	614.2	
Debt Service Payments	34.7	50.3	65.0	76.2	93.1	105.0	
Interest	13.6	19.4	28.0	40.4	54.0	57.4	
Principal	21.1	30.9	36.9	35.8	39.1	47.6	
Ratio debt to exports	126.4	130.2	117.2	111.0	123.8	143.6	
Ratio debt to GDP	27.4	27.9	26.8	26.9	30.4	35.8	
Ratio debt service payments to exports	15.4	19.0	19.0	17.6	20.1	23.4	
Latin American Countries							
Total External Debt	105.7	133.0	166.4	205.2	258.8	289.8	310.2
Net payments of interest and profit	8.5	10.5	14.1	18.5	28.0	37.0	33.9
Exports	48.2	51.8	69.6	90.5	96.8	88.6	87.5
Ratio debt to GDP	23.9	26.3	28.4	30.3	32.2	33.7	35.7
Ratio debt to exports	191	216	202	194	212	260	282
Ratio interest to exports	12.4	15.5	17.4	19.9	26.4	38.3	35.0

Sources: E.Brau, et al., "Recent Multilateral Debt Restructurings with Official and Bank Creditors," International Monetary Fund, December 1983, page 4; U.N. Economic Commission for Latin America, "Adjustment Policies and Renegotiation of the External Debt," February 22, 1984.

TABLE 12

Automotive Trade by World Region, 1978-1983
($billion)

		1978	1980	1981	1983	Change 78-83	81-83
Japan	Exports	0.2	0.2	0.2	0.2	0.0	0.0
	Imports	8.2	11.4	13.0	14.9	6.7	1.9
	Balance	-8.0	-11.2	-12.8	-14.7	-6.7	-1.9
W.Europe	Exports	0.9	1.3	1.3	1.1	0.2	-0.2
	Imports	5.1	6.2	5.4	7.2	2.1	1.8
	Balance	-4.1	-5.0	-4.1	-6.1	-2.0	-2.0
Canada	Exports	9.3	8.9	10.1	12.2	2.9	2.1
	Imports	10.4	8.6	10.4	16.6	6.2	6.2
	Balance	-1.1	0.3	-0.3	-4.4	-3.3	-4.1
Latin America	Exports	2.0	2.9	3.6	1.5	-0.5	-2.1
	Imports	0.6	0.6	0.8	1.7	1.1	0.9
	Balance	1.5	2.3	2.8	-0.3	-1.7	-3.1
Total	Exports	14.5	15.9	18.0	16.8	2.3	-1.2
	Imports	24.3	27.1	29.7	40.8	16.5	11.1
	Balance	-9.9	-11.2	-11.7	-24.0	-14.1	-12.3
Total w/o Canada	Exports	5.2	7.0	7.9	4.6	-0.6	-3.3
	Imports	14.0	18.5	19.4	24.2	10.2	4.8
	Balance	-8.8	-11.5	-11.4	-19.6	-10.8	-8.2

Source: FT 990, Highlights of U.S. Export and Import Trade, by "end-use" commodity category. Imports f.a.s. for 1978,1980; customs value for 1981,1983.

Total	Exports	14.3	15.8	18.5	17.2
	Imports	25.9	28.3	30.6	42.2
	Balance	-11.5	-12.5	-12.1	25.0
Total w/o Canada	Exports	5.3	7.1	8.4	4.9
	Imports	14.7	19.5	20.1	25.3
	Balance	-9.5	-12.4	-11.7	-20.4

Source: International Trade Commission

Note: Due to rounding, figures may not add or subtract as shown.

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TABLE 13

Automotive Trade (excluding Canada), by Type of Product
($ million)

		1964	1968*	1973	1978	1980	1982	1983
Total**	Exports	2,383	1,283	1,892	5,262	7,092	7,100	4,921
	Imports	712	1,807	5,449	14,731	19,464	20,853	25,271
	Balance	1,671	-524	-3,557	-9,469	-12,371	-13,753	-20,350
Passenger Autos	Exports	270	118	215	956	884	517	386
	Imports	560	1,433	3,716	9,583	12,877	14,392	17,067
	Balance	-291	-1,315	-3,501	-8,627	-11,993	-13,875	-16,681
Trucks & Truck Tractors	Exports	372	170	203	920	1,143	1,264	754
	Imports	7	3	276	1,225	1,830	1,495	1,764
	Balance	366	167	-73	-305	-687	-232	-1,010
Motor Vehicle Parts	Exports	1,653	858	1,246	2,484	3,883	4,259	3,323
	Imports	123	329	1,376	3,768	4,573	4,587	6,028
	Balance	1,530	529	-130	-1,284	-690	-328	-2,705

* first year of a deficit in overall auto trade

** total includes buses, special purpose vehicles and snowmobiles in addition to passenger cars, trucks and parts

Source: International Trade Commission

Note: Due to rounding, figures may not add or subtract as shown

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TABLE 14

Sources of Auto Parts Imports
($million)

	1980	1981	1982	1983
Japan	1,336	1,822	1,822	2,113
Mexico	310	419	648	1,208
Federal Rep. of Germany	797	586	507	631
Brazil	223	247	310	424
France	454	390	295	324
Korea	120	164	189	254
Taiwan	110	118	134	248
U.K.	299	261	190	232
Total	4,620	4,551	4,586	6,028

Source: International Trade Commission

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Chairman **Gibbons**. Well, both of you presented some very interesting testimony.

Mr. Oswald, I want to assure you, because you bore down most hard on this, that I recognize that you criticize my legislation as being very small and very narrow. But I don't intend to stop with it. The agenda goes on. I try to take up enough at one time so that we can understand what we are doing, because this is an extremely complex area that we are legislating.

I think we have made some progress in understanding the problem a little better, and both of you have helped us with that.

Thank you very much.

Mr. **Oswald**. Thank you, Mr. Chairman.

Chairman **Gibbons**. Mr. Harry Freeman from the American Express Co. Mr. Freeman, we welcome you here. We know it has been a long morning, but you may proceed as you wish.

STATEMENT OF HARRY L. FREEMAN, SENIOR VICE PRESIDENT, CORPORATE AFFAIRS AND COMMUNICATIONS, AMERICAN EXPRESS CO.

Mr. **Freeman**. Thank you very much.

I would like to submit my statement for the record, and I have a relatively brief oral statement to make, Mr. Chairman.

My name is Harry Freeman. I am the senior vice president of American Express Co. I am also vice president of the Coalition of Service Industries, a group of 30 U.S. large exporters of services.

My thesis today, in addressing the increasing U.S. trade deficit, is really a very simple one. I left others to address the very difficult and real problems of our industrial and agricultural industries and of the incredible size and consequence of our increasing trade deficit.

I will address today the increasing problems of the U.S. service exporters. The message is plain. The traditional trade surplus from U.S. service exports is declining rapidly. The surplus shows no sign of bottoming out, let alone of increasing. That service surplus used to help offset the deficit in manufactured goods. Those good old days are gone. I hope not forever.

Yet U.S. service exporters who are facing increasing trade barriers abroad do not have now the benefit of most American laws concerning trade disputes and trade remedies. Increased fair competition is something that in our view American service exporters must learn to live with. We must keep ourselves tough and lean to maintain or increase our market positions. I believe, Mr. Chairman, that the U.S. service exporters are extremely competitive. We are tough and lean, and we are doing very well.

It is what Mr. Schulze said about an hour ago that concerns us. He said, "in looking back, how could American business in some areas be so dumb as not to see what was going on?" Well, as we look at what is happening today, and more importantly what trends are evolving, we must talk about the problems we see coming over the horizon now and not wait until it is too late.

Not having recourse to the trade laws and trade remedies of the United States as other exporters do, strikes me as unacceptable, somewhat incomprehensible, but fortunately quite remedial. Legislation has been pending in this Congress since 1983 which would place service exports on par with goods exports. It hasn't gotten over the goal line yet although it has been passed by the Senate twice last year, and is awaiting passage for the third time.

The chairman of this committee and some of his colleagues have been the leaders, the proponents of this legislation. We have walked a long road together. I would like to ask the chairman and this committee to renew those efforts and get this legislation passed and on the books this year.

Perhaps some statistics, will remind us where we are and help make the challenge clear. Manufacturing jobs now constitute 20 percent of U.S. employment, down from 25 percent 10 years ago. Contrary to some notions, manufacturing jobs have risen in the United States in the last 10 years. According to last week's Business Week manufacturing jobs have risen by 343,000—not enough, but they have gone up.

Service sector jobs now account for 69 percent of total U.S. employment. According to the April 9, 1984, Wall Street Journal, that constitutes an increase of about 20 million jobs over the last decade. That is where the new jobs have come from, and contrary to what Mr. Price stated a few minutes ago, many of those jobs have done from business services that have been exported.

Incidentally, for comparison here are the percentages of services jobs in some of the other major industrial economies: France, 58 percent; Japan, 56 percent; United Kingdom, 63 percent; Germany, 53 percent.

World trade in services is estimated now at around $700 billion, about one-fourth of all trade. The statistics we have, however, are very poor.

Europe now exports more than three times the amount of services the U.S. exports. This fact, I think, is little appreciated. The United States, exports roughly at the same size of exports as the United Kingdom, France, and Germany. According to Business Week, March 19 of this year, France is probably the second largest, if not the largest, exporter of services in the world today and is producing a major services surplus.

Unfortunately, U.S. service exports actually shrank in 1982. Estimates for 1983 show further decline in U.S. service exports. The U.S. service surplus narrowly defined as business services, not including the return on investments from abroad, has declined in 1983 to about $6.5 billion. In 1982 the surplus declined to roughly $7.5 billion.

So we are seeing a decline in this traditional services surplus, at a time when the United States can least afford it because of the size of our merchandise trade deficit. In November 1982, at the GATT ministerial, the United States delegation led by Bill Brock and the members of this committee, led the charge toward the GATT negotiations for liberalizing service sector regimes. We met lukewarm support due to the belief of our trading partners that only the United States stood to gain. But since that time, some key countries have seen self interest prevail over their initial disinterest.

The EC Commission made a startling announcement in November of 1983, saying that after having finally done its homework, it realized the service exports from EC countries were more than triple those of the United States. Perhaps they reasoned the time had come for the rules of the game to protect their own service exports.

So having initiated a global move, the United States has now been joined by the Common Market Commission in that effort. But support for this initiative has been very lopsided in the United States. Progress has been made somewhat in the executive branch, but notwithstanding major efforts by several individuals in both Houses, in particular in this subcommittee, Congress has done little to bring the U.S. trade laws up to date.

For those who would confine their interests to our deficit in industrial trade and the resulting job displacement or job decline, I would say this. The export of goods and services are so intertwined that one needs the other. For example, if you want to produce more jobs through the export of major industrial equipment, U.S. engineers working on projects abroad may very well generate demand for such equipment. Yet, U.S. engineering companies are facing tougher and tougher competition and increasing trade barriers in their overseas operations. They need the laws on the books to help them compete and overcome these barriers.

To those who oppose legislation to expand and liberalize trade and services, I can only say I don't understand their arguments. We are in a difficult situation. We are now pointing out that that traditional surplus in actual services exported is declining. The signals are clear. We still have time to get the legislation that we need through the Congress this year.

I would like to make one final comment about DISC. DISC and the so-called FSC proposal designed to replace DISC, do nothing for services. Therefore, we don't think FSC would be such a good idea. As a matter of fact, I have had a chance to talk with officials of the common market, and they say that FSC is not GATT compatible. I don't know whether this information has been presented to this subcommittee, but that seems to be the opinion of the EC.

So, FSC, would be perceived, according to my European colleagues and a lot of trade officials in Europe with whom I spent last weekend, as adding insult to injury. I think FSC ought to perhaps be sent back to the drawing board for further review.

I realize that the FSC proposed it is not in the House tax bill. It is in the Senate bill, and you will have to consider it on that context soon.

My final note here, Mr. Chairman, is to renew my plea. We have talked many times trying to get the trade in services bill through the Congress and to the President for signature.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF HARRY L. FREEMAN, SENIOR VICE PRESIDENT, AMERICAN EXPRESS CO.

Mr. Chairman, distinguished Members, my name is Harry L. Freeman and I am a Senior Vice President of the American Express Company. I am also Vice President of the Coalition of Service Industries, an industry association which represents thirty of the nation's largest U.S. exporters of services.

These hearings have been called in order to examine the causes behind the growing U.S. trade deficit, which today is accumulating at the unprecedented rate of over $10 billion per month. Last year the U.S. trade deficit reached an historic high of $69 billion. This year it is projected to grow by 44 percent to over $100 billion.

By any standard these figures are impressive and troubling. The causes behind this historic deficit urgently require the time and attention of our leaders in the public and private sectors. Rather than ask ourselves, however, why Americans are importing so much, I think the question should be turned on its head. We should be asking ourselves, why are Americans exporting so little?

I will leave it to others to address the very difficult problems faced by the exporters of our industrial and agricultural products. Instead, I will address the growing problems faced by U.S. exporters of services. Their message is simple and direct: the traditional services trade surplus generated by our services exports is declining rapidly and showing no signs of bottoming out let alone growing again.

This is important, even crucial to the question of why the U.S. trade deficit is reaching such historic heights. In the past the services trade surplus we have taken for granted has helped to offset our chronic and growing merchandise trade deficits. According to a recent article in the New York Times, over the past decade the rising overseas income from the nation's banks, insurance concerns, construction companies and other service exporters has more than offset our merchandise trade deficit thus allowing the nation to run a surplus in its current account.

In addition, services exports have generated overseas demand for America's goods. According to an International Trade Commission study released in 1982, U.S. services firms surveyed generated a minimum of $3.4 billion in exports of U.S. goods. This is not surprising. There is a natural linkage between tangible production and intangible activities. Thus an American engineering firm working a project in Saudi Arabia is likely to order the heavy equipment and supplies it needs from U.S. manufacturers.

In light of all of this, it won't come as a surprise that services generate jobs here at home. Nevertheless, I think a few statistics may help to make this clear.

1. Manufacturing jobs now constitute about 20 percent of total U.S. employment, down from 25 percent ten years ago.

2. Nevertheless, the number of manufacturing jobs has risen in the U.S. during the past ten years by 343,000.

3. Service sector jobs now account for 69 percent of total U.S. employment—up from 64 percent a decade ago.

4. By comparison, here are the percentages of services jobs in some of the other major industrial economies:

	Percent
Japan	56
United Kingdom	63
France	58
Germany	53
Italy	50

5. World trade in services (also known as invisibles) is estimated to be approximately $700 billion, perhaps as much as one quarter of all trade.

6. Europe exports more than three times the amount of services exported by the U.S. By subtracting tourism and shipping, the U.S. ranks fourth among the leading exporters of services, after the United Kingdom, Germany and France.

Today, unfortunately, those "good old days" of rising services surpluses are gone. Since 1981 our services trade surplus has shrunk by 25 percent, from an estimated $39 billion in 1981 to an estimated $30 billion last year.

There are many reasons for this decline. At the heart of the matter, however, lie two converging trends. First, increasing foreign competition in services trade is rapidly reducing U.S. market share. According to the U.S. Trade Representative's office, the U.S. share of world trade in services shrank from 25 percent in 1972 to 20 percent in 1981. Increasingly, U.S. services exporters face keen competition in the fields we have traditionally dominated such as telecommunications, finance, construction engineering and transportation.

In our view, foreign competition is something America's services companies must learn to live with. The fact is anyone wishing to compete in world markets must be "tough and lean," and I am confident American services firms can meet and beat the foreign cometition. However, if our task is clear, the playing field on which we struggle is frequently obscured by gaps or inequities in our own laws.

For example, no one really knows how well or how poorly American companies are facing up to foreign competition. The limited overseas performance statistics collected by the U.S. government on U.S. services companies provide only a fraction of the total picture. In effect, we have set off on a difficult journey, over unknown terrain, with only a fragment of a map.

The second trend contributing to the decline in our services trade surplus consists of growing foreign protectionism against U.S. services exports. Today increasing numbers of nations seek to protect their emerging service sectors from foreign competition through a myriad of non-tariff barriers. Examples of these may be found:

In Argentina, where American accounting firms are limited in the number and type of audits they can perform.

In Italy, where no foreign advertising agency is allowed to offer services and all TV commercials produced outside of the country are forbidden.

In Germany, where foreign banks are prohibited from offering or providing services, only representative offices are allowed in the country.

And the list goes on. The point is, U.S. services companies are severely handicapped in their efforts to deal with these trends both by the fact that U.S. trade law is biased in favor of goods and by the fact that services are excluded from the international body of trade law known as the GATT.

Not having recourse to international trade laws embodied in the GATT strikes me as unfortunate. As you know, Mr. Chairman, in November of 1982 at the GATT Ministerial, the U.S. led the fight to launch GATT negotiations on trade in services. That effort was only partially successful. Rather than launching a GATT work program on services, the ministers called for member countries to conduct their own National Studies on Services. Since then, many of the countries which initially opposed the U.S. initiative have, upon investigation, discovered their own stake in services trade. The EEC, for example, has announced that services account for over 30 percent of its total exports. As a result the U.S. has been joined by the EEC and several other countries in an effort to integrate services into the GATT.

On the other hand, not having recourse to the trade laws and remedies of the United States—as other exporters do—strikes me as unacceptable, incomprehensible and—fortunately remediable.

Since 1983, legislation has been pending in this Congress which would grant services exports parity with goods in U.S. trade law. This bill, variously known as S. 144, or the International Trade and Investment Act, has been passed by the Senate three times. Recently, it was attached to the House-sponsored Miscellaneous Tariff bill H.R. 3398 which is now awaiting action on the Senate Floor. Still it hasn't gotten over the goal line. Similar bills are also awaiting action in the House.

In brief, this important legislation would accomplish three goals of great importance to the competitive position of U.S. services exporters.

1. It would grant services full parity with goods under U.S. trade law, particularly with regard to Section 301 of the Trade Act. This would enable U.S. trade officials to pursue bilateral as well as multilateral agreements to liberalize trade in services.
2. It would create a Congressional mandate authorizing the President to carry out negotiations leading to the incorporation of services into the GATT.
3. It would establish a clear priority for the improved and expanded collection and analysis of service industry performance data by the U.S. government agencies.

The Chairman of this Committee and some of his colleagues have long supported the passage of this legislation. We have walked this long road together. As the growing U.S. trade deficit makes clear, however, passage is needed now more than ever before. I ask him to renew his efforts in this body with the other appropriate committees of the Congress to achieve this important goal.

Chairman **Gibbons**. Sir, you have got a good point. As you know, we have voted it out of the Ways and Means Committee, and it now resides over in the Commerce Committee. We have been trying to work with those folks to get them to turn it lose. We have not been successful. I think that would be the appropriate place to put the pressure on, if you can.

I was surprised at those figures about France being the second largest exporter of services. What makes them so good? Why do they provide so many services?

Mr. **Freeman**. They are doing a lot in software I believe, and a lot of servicing in oilfields—a lot of knowhow exports. Three of the ten largest banks in the world, I believe are French. Yet, 10 or 15 years ago, most if not all of the big banks were American. I think out of the top 20, there are now only 3 American banks and only 4 or 5 large French banks.

The French are doing a lot in insurance too.

They are rapidly expanding their service exports.

Chairman GIBBONS. That is amazing. I wasn't aware of that.

Mr. FREEMAN. Their engineering and construction companies are very globally oriented. They are tough competitors. Our companies are tough competitors too. The Government of France, of course, owns many of these companies. The export credits support is very strong in France. They are tough to compete with.

Chairman GIBBONS. You mentioned that, and I am trying to pull information out of you because I was so surprised by that figure. Do you think the French have been subsidizing their exports in services?

Mr. FREEMAN. I can't make that allegation. I don't have enough information. It would not, however, come as a great surprise to me. I know that the Chairman of the Export-Import Bank, Mr. Draper, was in Europe last week pleading with the OECD to come to some kind of agreement on export credits and on the use of foreign aid or concessional aid as an element of export credits. This has been a longstanding problem.

France has very large foreign aid programs. I can't say now that France is a major subsidizer of service exports, but if it were true, it would come as no surprise.

Chairman GIBBONS. I am sorry to hear what you say about FSC. FSC is in the full Ways and Means Committee. It is not in our subcommittee, and I hope that that is just the Europeans talking. I don't know whether they can prove that case when they get in the GATT.

Mr. Jenkins.

Mr. JENKINS. Thank you, Mr. Freeman, for your testimony. I have no questions.

Chairman GIBBONS. Thank you very much.

If we can help you over there in the Commerce Committee, let us know. I have tried everything I know. I will keep at it.

Our next witness is from the American Fiber, Textile & Apparel Coalition, Mr. Chaikin, president of the International Ladies' Garment Workers' Union. I hope Evelyn won't get mad at me for saying this, but I always thought she was president. I am teasing here. I don't know of anybody who works harder and more effectively.

STATEMENT OF SOL C. CHAIKIN, PRESIDENT, INTERNATIONAL LADIES' GARMENT WORKERS' UNION, AFL-CIO, ON BEHALF OF AMERICAN FIBER, TEXTILE & APPAREL COALITION

Mr. CHAIKIN. I am sure she is glad to hear that, and so am I, Mr. Chairman; for many years I, too, have been laboring under the illusion that she is the president.

Chairman GIBBONS. She does a fine job.

Mr. CHAIKIN. Thank you, Mr. Chairman, and members of the committee for the opportunity to address the question of America's massive merchandise trade deficit. My name is Sol C. Chaikin, and I am president of the 270,000-member International Ladies' Garment Workers' Union. I have also been asked to speak on behalf of the American Fiber, Textile, & Apparel Coalition, a nationwide group of apparel and textile workers and employers, both union and nonunion.

The erosion of the Nation's merchandise trade position, to the point of unprecedented deficits in nearly every industrial sector, results from a number of factors, not the least of which is the rapidly increasing deindustrialization of our Nation and the very perception of the role of trade in our national economy. Little attention is paid to these factors. The decline of American manufacturing has led to a host of additional adverse developments.

Before I express some specific thoughts on the merchandise trade deficit and an approach to possible ways of dealing with it, I would like to say a few words about its interrelationship with employment, innovation, and competitiveness and the role played by the Federal deficit and high interest rates. My approach is somewhat different from the traditional. My concern is not only the effects of trade on the national economy but also how past and current trade policies affect ordinary working people.

Since 1968, nearly 2 million production worker jobs in manufacturing have been lost, in part the result of the recessions, in part the result of trade policies. In the same period, the number of jobless increased nearly fourfold. As the current recovery has developed, more than 1 million manufacturing workers, idled by the recession and the replacement of U.S.-made products by imports, have not been recalled.

More than 9 million Americans, we are told, are jobless. This figure underestimates the true level of suffering. Because of our narrow definition of unemployment, the data generally cited do not reflect discouraged workers who are no longer actively seeking employment and those working short hours who wish to work a full workweek. Add these workers to the official figures and the actual number of jobless rises to 14 to 15 million and the percent unemployed from 10 percent to 11.5 percent.

Anticipated increases in high tech employment will not arrest the decline in potential purchasing power resulting from ongoing high unemployment. Very few such jobs are skilled and relatively highly paid and all high tech industries combined are estimated to provide fewer than 250,000 new jobs during the balance of this decade. Continued loss of our goods-producing base will, therefore, undermine one of the keys to America's historic broad-based prosperity.

Aside from the social costs, the loss of Federal income as a result of unemployment has added enormously to the already staggering Federal deficit. The Congressional Budget Office estimates that the Federal Government loses $30 billion each year, in increased outlays and diminished revenues, for each 1 million unemployed.

Overvaluation of the U.S. dollar relative to other currencies is frequently cited as a key recent cause for the declining competitiveness of American-made goods. The high dollar, in turn, results from budget-related high interest rates. Even if it were politically achievable, however, an immediate decline in the value of the U.S. dollar by 20 to 30 percent, the generally accepted level of overvaluation, could involve some real dangers. We have, in fact, been painting our economic circumstance into a corner.

Crippled as we are by unprecedented Federal deficits, with massively larger shortfalls anticipated in upcoming years, interest rates continue high and are attracting a great amount of foreign capital to American shores. Higher interest rates and consequently higher deficits could well be the result as the demand for capital by government and the private sector collide. Recession and rising unemployment, as in the past, would no doubt accompany rising interest rates.

Sudden devaluation of the dollar at this time could lead to a rapid outflow of foreign capital, creating even greater pressures on interest rates. This may occur because a general lowering of domestic interest rates could lead to repatriation of foreign capital to its countries of origin.

Currency exchange or interest rate manipulation provides no "quick fix." Lowering of interest rates and devaluation must be coupled with efforts to address the causes underlying America's economic problems and our declining competitiveness. The often suggested response in terms of Federal Reserve Bank policy simply postpones attention to the basic causes of our present dilemma. We must, therefore, in my opinion, address some of the causal factors in the mismanagement of our economy.

In part, our dilemma today results from the use of capital to further the ever-growing concentration of ownership. This is a major factor in discouraging investment domestically in state-of-the-art technology and a decline in the incentive to compete. The oligopolistic nature of most capital-intensive industries has also been a major factor in the failure to improve product and production techniques, resulting in a diminution of consumer confidence and shrinking market shares here and abroad.

America's ability to innovate and to compete have also been negatively affected by the diversion of huge amounts of corporate capital from new productive domestic investment in this country. From 1950 to 1982, direct foreign investment by U.S.-based multinational corporations expanded from $11.8 to $221.3 billion, an average annual growth rate of nearly 10 percent. The comparable average for domestic investment in the same years was less than 7 percent.

We do not know how much of these domestic funds were actually used for productive investments. In recent years, massive amounts of corporate money, assisted by our current skewed tax policy, have been used for speculative purposes or to finance corporate mergers or acquisitions of existing facilities. Such investments do not assist domestic employment, production or competitive growth. One of the more dramatic examples in recent years has been U.S. Steel's $6.6 billion takeover of Marathon Oil while its steel sector has suffered for decades from a lack of modernization needed to compete with foreign firms in our own and in foreign markets. We are currently being treated to a spate of unproductive absorptions of one oil company by another. No benefit accrues to domestic—or world—competitiveness.

These comments are more appropriately directed toward the capital-intensive sectors of the economy. In labor-intensive industries, such as apparel, no single manufacturer represents as much as 1 percent of domestic production and there are more than 25,000 firms engaged in the kind of cutthroat competition that is impossible and unheard of in steel, auto, aerospace and high tech. Competition and ease of entry characterize the industry to such an extent that Adam Smith, were he alive today, would use the apparel industry as a classic textbook example, perhaps the only one remaining, of a truly free, democratic, competitive industry.

The basic production factors also relate differently in labor-intensive industries than in the capital-intensive or high tech industries. Wages are the largest single element affecting production costs in labor-intensive industries, and they are among the lowest in domestic manufacturing. American garment workers, for example, earn an hourly wage of $5.85, union and nonunion, plus fringes. This compares with an average wage in manufacturing of $9 per hour. In auto and steel, the hourly rate of pay is, of course, considerably higher than the national average, ranging from $11 to $13 plus fringes.

Labor-intensive manufacture requires limited capital. The requisite machinery is low tech, of simple design and comparatively inexpensive. It is the adroitness of the individual worker, not the sophistication of machinery, that determines product quality and productivity. These circumstances characterize such industries worldwide—in both developed and developing nations.

In most labor-intensive industries, no producer can exert any measure of control over its market; effective control is vested in a comparative handful of retailing conglomerates.

At the height of foreign competition in the auto industry, abetted in part by the high dollar, in part by the lack of competitive innovation, 27 percent of domestic sales went to imports. In the case of steel, import penetration represents about 22 percent of the domestic market for many of the same reasons.

I do not mean to minimize the impact of these imports on jobs in these industries. However, such import levels were surpassed many years ago in most labor-intensive industries, some of which have been virtually eliminated. Home electronics is one such example and non-leather-shoe manufacture is rapidly becoming another.

In the case of apparel, in 1983 fully 45.5 percent of the domestic market was taken over by imports and the figure is still rising. In women's apparel, the penetration rate was well over 50 percent. Net clothing and textile imports on a customs basis accounted for an average of 20 percent of the Nation's total merchandise trade deficit from 1979 through 1983. On a CIF basis, apparel imports represented 15.3 percent of the merchandise trade deficit in the same 5 years. In the same years, the dollar value of the trade imbalance in clothing alone grew by a staggering 82.9 percent using the first measure, and 76.8 percent using the second.

In the first 2 months of this year, total textile and apparel imports were up 44.9 percent. A clear danger of future import penetration growth is the apparent shifting of production by some of the current major suppliers to even lower wage nations, such as Indonesia, Singapore, the Philippines, and Malaysia. This can result in further massive import growth because these countries have large amounts of unused quotas.

Despite the toll which imports have taken, labor-intensive industries still provide fully 42 percent of American manufacturing employment, roughly some 8 million out of 19 million jobs. Indeed, the Nation's single largest industrial employer is the apparel-textile complex. These two industries are closely related, one as a supplier to the other. With 1.8 million jobs currently—a drop from roughly 2.5 million in 1974—the textile-apparel complex employs approximately 1 out of every 8 American production workers, more than basic steel, auto assembly, and chemical refining combined.

Despite low domestic wages and competitive pricing, importers of labor-intensive products have sought out those parts of the world where wages and living standards are even lower, where poverty effectively becomes the measure of "comparative advantage." In the apparel industry, this has resulted in a loss of more than 300,000 jobs during the last 10 years.

I might add, parenthetically, that the same number, and perhaps a few more, have been lost in the great textile industry of America. The loss is directly and primarily attributable to a surge of imports from nations where wages are abysmally low and human rights and the rights to organize are virtually nonexistent.

Chairman GIBBONS. Excuse me. Could I stop you. Mr. Jenkins and I are going to have to run and vote, and we will come right back. They have got a vote on. We will be right back.

[Recess.]

Chairman GIBBONS. We will resume again, please.

Mr. CHAIKIN. Thank you, Congressman Gibbons.

The major problem confronting the apparel industry in this country and our substantial apparel trade deficit will not be resolved by legislation to increase export-import lending authority, efforts to eliminate foreign subsidies of exports or provide similar U.S. Government subsidies to American companies, or reciprocity legislation. Nor will it be resolved by bank loans, technological changes in manufacture or "shaking out" the industry.

Our competition, assisted further by the high dollar, is the wage differential between low-paid U.S. workers and unconscionably low-paid workers in Third World countries. More than 70 percent of imports of women's apparel originates in four nations: Hong Kong, with an applicable wage rate of $1.18 per hour; Taiwan at $0.57; South Korea, $0.63; and the People's Republic of China, where a garment worker earns the U.S. equivalent of $0.16 per hour.

The designs they use as well as the machinery and production techniques, are either copied from the United States or freely given by U.S. importers. Marketing networks are readily provided by the major retailers, who increasingly have become direct importers. The only "comparative advantage" provided by these developing nations is the great disparity in living standards between America and the nations which provide the bulk of labor-intensive products.

The rising share of the apparel component of our merchandise trade deficit is thus inextricably linked to the excessively high levels of imports from the Third World and the extremely low living standards in these nations. Our apparel exports are comparatively minuscule. The only possible justification for permiting this to continue is the theory that tells us that our consumers benefit because low-wage labor is reflected in lower retail prices. This is not the case in apparel. Almost invariably, imported goods retail for the same price as domestically produced items of precisely the same design and style.

Apparel imports are advantageous to the importing retail chains because they can be marked up to the same retail price as domestically produced apparel, providing bloated profit margins. Imported apparel, therefore, takes center stage in displays and advertising, as well as on the clothing racks.

Concern has been voiced about the effect of reduction of imports from the less developed nations on efforts to eradicate Third World poverty. Our national experience with the Marshall Plan and with our policy toward Japan in the immediate post-World War II period demonstrated the potential of trade as an instrument in promoting human rights and in raising living standards.

American trade policy toward postwar Japan, for example, was only one component of a comprehensive plan that included the establishment of institutions necessary to the existence of a participative democracy, including the establishment of an independent labor movement. Such measures have been noticeably absent from our economic policies toward today's developing nations.

Despite greatly expanded exports to the United States and other developed nations, a special report to the Secretary of the UNCTAD, entitled "Trade and Development in the Eighties," noted that income distribution in the Third World has become less equal and that the poorest 10 to 20 percent are actually worse off than they were 25 years ago.

In the developing nations, ruled by autocrats, it is easy to keep wages artificially low. In the developing nations, ruled by dictators of the political left or right, it is easy to keep the work force in line. Among the incentives for such repressive measures is the certain knowledge that there are other developing nations eager to host foreign investment where the living standards are even lower. This is in stark contrast to our Nation's original goal of fostering the emergence of stable, prosperous democracies worldwide.

The distortions which occur when poverty becomes the measure of "comparative advantage" are amply demonstrated by the four major apparel-exporting nations. Four Asian regimes, as I have said, control more than 70 percent of the American market for imported apparel. Three of them, Korea, Hong Kong, and Taiwan, are demonstrably newly industrialized countries. They are capable, according to conventional wisdom, of sustaining economic growth without excessive dependence on labor-intensive exports. They are producers of steel, auto and high tech, and many other items. The remaining 30 percent of the U.S. apparel import market is spread thinly among 143 other nations. This lopsided relationship serves to undermine much of whatever positive foreign policy benefits should flow from the sharing of our domestic market.

If sharing such extremely large portions of the domestic American market does not help either Third World workers, their American counterparts or the American consumer, who benefits? I reiterate, the evidence points to the retailing conglomerates in this country, to the banks, and to the elites of the Third World.

A rational trade policy is crucial if we are to maintain what remains of labor-intensive industries and the jobs they offer to our own underprivileged. A policy based on the expendability of labor-intensive manufacturing, one that views some industries as "sunset" industries that should pass out of the picture and give way to high-tech industries, is clearly unacceptable. Such a cavalier attitude ignores the fact that workers in labor-intensive industries are overwhelmingly women, with disproportionately large numbers of minorities and recent immigrants.

While wages in labor-intensive industries may be low in comparison to steel, auto, aerospace, rubber, or refining, they are, nonetheless, higher than in comparable jobs in the service sector, which tend to gravitate around the minimum wage. Is this truly the direction our Nation wants to follow: low-paid workers who cannot buy back what is produced by capital-intensive and high-tech industries? Are we prepared to see an America with ever lower living standards?

The effects of joblessness among our well paid workers, as well as the downgrading of higher paid workers will translate into greatly diminished purchasing power. This should be a matter of deep concern in an economy whose growth and prosperity is fueled by consumer purchases.

Although the textile-apparel complex is sometimes referred to as "the most protected segment of the U.S. economy," massive and accelerating levels of import penetration demonstrate that existing measures are wholly inadequate.

Textile and apparel imports in 1984 will almost certainly be 1.4 billion square yards more than in 1983. According to industry figures, this increase in imports is the equivalent of 140,000 American jobs. This is the effect, however, in only 1 year. Cumulatively, apparel and textile imports have cost our Nation more than 750,000 job opportunties.

In a 1980 letter to Senator Thurmond, President Reagan said that he would relate import growth from all sources to domestic market growth. In 1983, the rate of increase in apparel imports reached staggering levels. Apparel imports of all clothing—men's, boys', women's, children's et cetera—were up 14.3 percent over the prior year and imports of women's and children's apparel alone, the industry in which members of my union work, were 20.4 percent higher than in 1982. In 1983, domestic consumption of apparel and textile products grew at a far smaller rate and, over the long run, the domestic market is projected to grow at a rate of no more than 1½ to 2 percent each year. The rate of quota growth of textile and apparel imports from the People's Republic of China alone will exceed 10 percent per annum during the term of our most recently concluded bilateral agreement. This compares with less than 1 percent average quota growth for Hong Kong, Korea, and Taiwan, which export to the United States about 60 percent of the total of all imports of textiles and apparel.

The accelerating loss of market shares by domestic textile and apparel manufacturers has occurred despite the Multifiber Agreement and the 26 bilateral agreements we have negotiated with major suppliers under MFA.

Nor can the President's measure of December 16, 1983, be seriously expected to decrease the rate of increase in imports. Basic changes in the import program are needed if the President's earlier commitments to Senator Thurmond and other national political leaders are to be met.

A rational system of fair trade is the first step in a policy which will preserve the jobs provided by labor-intensive manufacture. Central to such a policy would be negotiated import quotas, which would provide for global allocations of shares of the American market. In the view of the ILGWU, reserving up to 25 percent of domestic consumption of labor-intensive apparel products for the output of all low-wage nations is more than an equitable amount. It assures the consumer of "freedom of choice" and permits domestic producers needed "breathing space." Furthermore, imports based on global quotas should be licensed by the U.S. government as permitted in the Trade Act of 1979 as a means of better control and in order to limit fraud and counterfeiting. Amendment of section 204 of the Agricultural Adjustment Act of 1956 to provide increased authority for unilateral controls of textile and apparel imports would also be helpful as a component of a more far-reaching trade policy.

Global allocation would also permit more of America's market to be shared by developing, rather than newly industrialized, nations. Moreover, developing countries would know the size of their U.S. market in advance and be able to plan accordingly. This would prevent the disruptions which flow from the rapid shift of a developing nation's market share to countries where living standards are even lower.

The absence of the orderly sharing of markets has contributed to the massive indebtedness of many Third World nations. Encouraged by the banking community and international lending agencies to adopt a strategy of export-led rapid industrialization, developing nations have borrowed heavily and often imprudently. Many developing nations have now lost the ability to provide for their own basic needs, particularly food. They have been compelled to import food as well as other key items needed in their economic structure, lessening their ability to repay their foreign debt. Now they are being pressured by the banks and international lending agencies to lower their living standards still further to repay their debts.

We must deal with these problems as matters of the highest priority if our Nation is not to suffer the consequences of the loss of millions of additional jobs. I cannot help but express the fear that, unless we develop and implement a policy of fair trade, the United States will, in short order, see its living standard eroded to the point where, farfetched though it may seem, we may begin to bear a similarity to countries of the Third World—a small group of wealthy people at the top, a low living standard for most of the population, and high levels of permanent joblessness.

Thank you, Mr. Chairman.

Chairman GIBBONS. Well, sir, that certainly is a very bleak picture of the future of your industry. I realize it is pretty tough to be optimistic in an industry that has had as much trouble as the apparel industry has had.

Certainly a less overvalued dollar would help, but it only helps marginally; is that right?

Mr. CHAIKIN. Congressman Gibbons, while I am aware that the strong dollar is a factor in many of our import and export circumstances, it is of no consequence whatever in the manufacture of ladies' apparel and the import competition from which we suffer.

To begin with, one or two of the nations which are the biggest exporters to the United States have currencies linked to the dollar, and so there is no real fluctuation in terms of relative monetary strengths and weaknesses. In the People's Republic of China, if they pay wages equivalent to about 16 cents an hour in a labor-intensive industry, there is no way, regardless of whether the dollar is strong or weak, for there to be competition on any rational basis.

We are in a very unique circumstance, and I wish to repeat for the benefit of the record, that the workers in this industry are notoriously among the lowest paid industrial workers in the United States. They are not the fat cats.

Second, our employers are not asleep. They are very creative, and very tough. They run lean and mean. There are 20-some-odd thousand of them competing daily for a share of the consumer's dollar. Not one of them is big enough to have much of an impression on the total overall market.

The designs are American designs, and the technology generally American technology.

The know-how has been American know-how implanted in these countries overseas. In truth, the original capital which provided the basis for the establishment of these factories was American capital.

It is not a case that we zigged when we should have zagged. It is not a case where we priced ourselves out of the market in terms of labor costs or that we were asleep and noncompetitive and fat and dumb.

We have always been a very highly competitive industry.

There are many hundreds of thousands of workers who are employed in this industry, which provides a threshold industrial opportunity for minorities, new immigrants, people in small communities spread right through across the United States; they have an opportunity to work hard, to be efficient and productive and to make a tough living. But at least they have a measure of self-respect, a measure of dignity, and a small measure of security because of their work and their own labor.

The textile industry had been equally hard hit. It is an industry that is more capable of becoming capital intensive. Although, as you know, Mr. Chairman, most of the workers are not members of unions and most of the large textile corporations do not enter into collective-bargaining relationships with the union. I must say in their defense that they have become quite capital intensive and they have plowed back in the last 6 to 7 years tremendous amounts of capital.

They have become somewhat more productive and somewhat more competitive as a result.

I think everybody must understand that if the apparel industry goes down it means that the domestic textile industry has lost about 50 percent of the value of all of its production because the apparel industry is the major segment among the customers for textile mill products, and that is why we have such an overriding community of interest.

We are not affected by a strong dollar or a weak dollar. We are affected simply and clearly because the only comparative advantage that exists in Hong Kong or South Korea or Taiwan, that exists in Bangladesh, Indonesia, Sri Lanka, and some of the Caribbean nations, Haiti, where the people work for 35 cents an hour and perhaps 40 cents an hour, in Central and South America where they work for hardly any more than that or in Mexico where they work for about the value of 50-some-odd cents an hour, the only comparative advantage is the abject poverty of the people who inhabit these countries and the wage structure in those countries are a reflection of their standard of living, which is poverty, a very low, poor standard of living. What we need is something innovative and perhaps something that must be distinguished from the remedies that other industries might seek and other worker organizations might seek when they are concerned with job preservation.

Reciprocity will not help us one bit if we cannot compete with the products from Taiwan in New York City or Miami, and all of the way stations in between, if we can't compete against those products here in our own ballpark. There is no way that we can export these products and compete with these countries.

If you want to subsidize the industry, I am sure that the businessmen in textile and apparel and clothing would welcome all kinds of moneys on a soft loan rate basis, but they don't ask for that.

They are accustomed to paying more than market interest. They are accustomed to a reasonably undercapitalized industry, by and large, and competing as tough and as hard as they can.

The average ordinary remedies contained, sir, in your bill, and Bill Frenzel's bill and other suggestions that I have heard in the form of a new industrial policy would not bear fruit nor be of much assistance. The multifiber arrangement has not helped at all as you can see from the extraordinarily accelerating increases in imports of textile and apparel into the United States year after year, coming to a point where, if this continues over the next 4 or 5 years, we will no longer be able even to exist.

Chairman Gibbons. You said that the only salvation that you could hope for is a better multifiber arrangement.

Mr. Chaikin. I don't know whether a better multifiber arrangement would be helpful. We need the political will to say to the exporting countries around the world that we are willing to share our great domestic market with them but we don't want to be so foolish and so stupid as to dump all of the jobs which so many of these workers need overseas.

What we have to do is to roll back, for example, the quotas which Korea has, which Taiwan has, which Hong Kong has. We have got to roll them back to some reasonable figure. We have got to keep the People's Republic of China at bay because they themselves have the capacity to just overwhelm not only the Common Market and the United States, but any country which imports items of textile apparel and clothing.

If we continue on this basis on into the future, there is no question in my mind and no question in the minds of people who own and run Burlington Industries, Cannon Mills, who own Darien-Milliken, the great textile complexes upon which hundreds of thousands of workers depend for jobs, there is no question that they will be less able to compete and their markets will be so restricted as to create turmoil.

The jobs of the 500,000 workers who are still employed in the manufacture of ladies' and children's apparel and the 450,000 to 500,000 who are employed in men's clothing and boys' clothing will be washed overseas within the foreseeable future.

There is no way that in this low-paid industry here in the United States where the average worker, union or nonunion, but just averaged out, hardly earn $6 an hour, can compete with wages of the Asian countries. There are fringe benefits which amount to perhaps another $2 or $2.25.

Imagine, the fringe benefits and the direct wages together in textile and apparel do not come up to the average hourly industrial wage in this country.

You might ask, why can't you compete? How can you compete in a labor-intensive industry where about 35 percent of the value of the product in America is direct and indirect wage cost, where if you use fabric made in America, again the wage in component of the fabric is not unreasonably high, according to American standards, how do you compete against a garment made in South Korea for 50 cents an hour where they use fabric made in Taiwan, which has a wage component of so very little per hour? Well, there is no way that there can be competition.

Our situation is not the case of cars made in Sweden or in France or in Germany or Japan, styled there, manufactured there; shipped into the United States and available for a consumer to buy or not to buy.

They don't make garments in Taiwan for the Taiwanese or in Hong Kong for the people in Hong Kong.

If you know anything about the size ranges of the female population in Southeast Asia, you know they are not comparable to the size ranges of the women in the Common Market countries or in the United States.

It is our patterns, our styling, our creativity, our know-how of how the production flows through the factory which has been implanted there and which is sent there before the beginning of each production season. And so the competition is on all fours.

It is not the question that they make better quality goods. They are all human beings, and highly trainable. I might add that the wage system in the United States is a piece work section work system where if workers don't produce as much as others they don't get paid as much as others.

They are literally in business for themselves. If they are highly motivated or they are in great need or are more productive naturally or have greater skill, they will exhibit that and be paid a little more than the person who works next to them who might not be endowed with the same physical qualities. Productivity, on the average, is about as high as you can get, whether the garments are made in Georgia, New York City, or Chicago or Boston or Los Angeles, and all of the small communities in New England and Panama and Virginia, Ohio, et cetera.

It is extraordinary that in ordinary colloquy between Members of Congress and economists and worker representatives and members of industry one cannot relate to the specific and unique problems from which we suffer in textile apparel and clothing as one huge complex, or which other small businessmen in labor-intensive industries suffer. I don't want to neglect that.

I think, Chairman Gibbons, you must be aware and I hope that Members of the Congress and the Senate and the Executive will be aware that, while everybody in America talks in terms of steel and talks in terms of oil and glass and rubber and things of that nature and, of course, high tech, that of the 18 or 19 million industrial workers which still exist in the United States about 8 million or more are engaged in labor-intensive industry.

We don't all make automobiles, steel, and we are not all employed by the huge monopolistic complexes of manufacturing in this country.

There are hundreds, thousands of items which used to be made in the United States which gave work to people who were not particularly highly trained, who did not have a large degree of scholarship, who did not qualify for secretarial and operational jobs, as sales people or office workers. They found that they could be productive and could make a living and could support their families even though the wages they received were low. They were in labor-intensive industry where they didn't have to read blueprints or run a machine that had sophisticated components and didn't have to have any special training in order to do so.

These are jobs where they came in unskilled, where they learned by precept and example. While learning and working, they became skilled. Surely they were worth what they were paid and in most cases somewhat more than that but because of the competitive nature of the industries, they were not able to get that better wage to which they may have aspired.

Labor-intensive industries still provides 8 million jobs. They are under attack. They have lost a great deal of work and they bid fair to continue to lose them in an accelerated manner. We have to guard against that because they will not be replaced in the high-tech future.

They will absolutely not be replaced in an age of greater use of robotics, in an age of computer-assisted manufacture, in an age of computer-assisted design. They will not be replaced because high-tech itself will bring a qualitative change to many of the manufacturing processes in this country.

Lastly, I would remind the Congress that the United States of America permits and indeed encourages the largest legal immigration of any of the Western industrial democracies, about 400,000 human beings a year.

We are proud of that great record of sharing the value we have and the opportunities that we have in this great country of ours, but the fact is that many of them are workers and many of them need job opportunities. Work in textile and apparel and clothing used to provide the beginning, the threshold industrial job opportunities. We had blacks up from the South who came 20, 30 years ago, who settled in many of the areas in the Northeast part of the country and perhaps the Midwest, who found work in these textile apparel and clothing operations.

Many Hispanic people have lately come to our shores, a large group from Puerto Rico, where they are already citizens of the United States, and many from other areas, including the Caribbean. These are the types of jobs they found, because they were not qualified for other things.

In short, Chairman Gibbons, we have what might fairly be characterized as our own Third World within the United States. They work at jobs that they could do, where they can earn a tough living, where it is not uncommon to find a husband and a wife or mother and daughter working in the same factory or in factories nearby to each other. They were able to support themselves and, thanks to Social Security, and a minimal pension at the end of 30 or 35 or 40 years of work, were able to live at a low scale, but at least decently with a measure of dignity. If we permit all of these jobs to be washed overseas, as indeed they are, these people will be the victims. There is no conjecture about it, no guess work about it, no particular argument about it.

You may argue with the auto workers that perhaps they ought to tighten their belts a little and with the automobile manufacturers, they they should be smarter and tougher and make more gas efficient cars. You may argue with the steel industry, that should recapitalize its plants, build ministeel plants. You may argue with some segments of American industry that maybe they have been somewhat fat and somewhat dumb over some past years. But those arguments do not apply either to the textile manufacturers or to the people who are employed in the making of lady's, children's, boy's, and men's clothing. The facts are on the record, that we are not the fat cats. We are tough, and we do the right things.

What is selling in American stores are American patterns. The only difference is that so much of them are made in factories overseas where workers in Bangladesh, for example, get 12 cents an hour, or workers in Red China hardly the equivalent of 16 cents an hour.

The highest wage is in Hong Kong. They earn the equivalent of about $1.10 to $1.18 an hour, and that is because Hong Kong has been moving toward higher value-added products. Their population is limited. A lot of the textiles and apparel really originate in Red China, comes into Hong Kong, and is shipped with a Hong Kong label into the United States, the Common Market, et cetera. Be that as it may, even if all of the apparel and textiles are now made within the Crown Colony of Hong Kong, they are shifting out of some of this production because of the competition from electronics and high tech. Their workers are being put to work making higher value-added products and the competition for a limited supply of labor has forced some wage rates to go up. As a result, some of the people who used to make apparel in Hong Kong are shifting production to such places as Sri Lanka, and Mauritius, the latter a country with only 200,000 or 300,000 souls in the Indian Ocean. And they are shifting garment manufacture to Indonesia. This is happening for two reasons: One, they can get cheaper labor; and, two, there are unused quotas under the MFA in these other countries. In Hong Kong, Taiwan, and many of the other traditional suppliers of apparel, they have come up to what their allowable quotas are. You can understand why, when just four countries, including Red China, ship in 71 or 72 percent of all of the imports of ladies' and children's apparel.

Chairman GIBBONS. Mr. Jenkins.

Mr. JENKINS. Thank you.

I am very familiar with one of the problems you have delineated not only in my area but particularly in my State. You indicated that the increase in imports in Japan in February of this year exceeded 40 percent; is that right?

Mr. CHAIKIN. Somewhat more than that, over the same period of 1983, sir; 1983 was a recordbreaker so far as the imports of textiles, apparel, and clothing, and the first 2 months of 1984 are so inordinately higher as to boggle the mind. Therein lies the basis for my prognosis or prophesy or just statement of fact, that, if this continues unabated, within the very near term a good part of the apparel and clothing industries will be inundated and disappear. And as they disappear, a major customer of the textile industry will disappear to the great detriment of the workers in both industries.

Mr. JENKINS. I have watched this problem for a long time, and I have seen the bilaterals and the MFA, and all of the avenues that have been pursued to give some assistance to the domestic apparel and textile industry.

All of these have failed for lack of implementation, or lack of ability to implement. Is there anyway that you know, in the absence of a global quota, to address this problem in a rational way?

Mr. CHAIKIN. I have kind of given up hope that the multifiber arrangement and the bilaterals that flow from that arrangement can effectively conserve the jobs of workers in the textile industry and in the apparel and clothing industries.

We really have to make a fresh start. Obviously, there could be some mechanisms which could be grafted onto the MFA, and, given the political will, there could be some negotiations which would serve to decelerate this rate of increase.

What we need desperately to save what remains of the industry is to roll back the proportion of imports. The penetration of imports into our domestic market of ladies and children's apparel now exceeds 50 percent.

Mr. JENKINS. Seventy percent of that is coming from four countries.

Mr. CHAIKIN. Yes.

Mr. JENKINS. We are shoring up the economies of Hong Kong and Taiwan, where we provide the defense. I simply do not understand.

Mr. CHAIKIN. Despite all of the opposition to global quota concept that I hear, I have not been able to come up with any alternative to addressing the particular ills of this industry, except a global quota.

When I see import penetration at 50 percent, some 45-percent penetration in all apparel across the board, and with no prospect of making much headway as far as the gap between labor costs, I do not know any other direction, as unattractive as that direction may be for many except some form of a global quota.

I know that is not too popular and may be very difficult to sell. I would have to agree with you; you fought some years in behalf of this industry, and I really think that this industry is totally different in terms of its requirements from other domestic employers.

So I simply want to tell you that I would hope that this Congress and this administration would finally recognize that if we are going to have an apparel industry and a textile industry, that we have to take some quick action. Otherwise, we are going to lose it totally.

Thank you, Mr. Chairman.

Chairman GIBBONS. Thank you very much.

Mr. CHAIKIN. Thank you very much.

Chairman GIBBONS. Very sobering.

Our final witness is Mr. Donald W. Bedell, a management consultant, and who is with Bedell Associates.

STATEMENT OF DONALD W. BEDELL, MANAGEMENT CONSULTANT, BEDELL ASSOCIATES

Mr. BEDELL. Thank you, Mr. Chairman.

Chairman GIBBONS. I know you have been here a long time today, Mr. Bedell.

Mr. BEDELL. Well, it has been very informative indeed.

Since the statement will be in the record, I do have a summary also. My summary is just one page.

Before I begin any quick summary—I won't read the statement or even the summary—I would like to say that I associate myself, generally speaking, with the position of Larry Fox this morning with regard to such matters as exchange rates, dispute settlement mechanisms, and administrative problems with regard to developing and implementing a trade policy that is effective, whether it is imports or exports.

What I would like to do, Mr. Chairman, is to say we need to make a wholesale reorientation of our commercial trade policy.

There are four myths that I identify, or fantasies, that have to be discarded before we can even attempt to establish the basis for a new trade policy.

The first myth assumes that the premise that economic nationalism in the world has at least magically given way to acceptance of the theories of Adam Smith and David Riccardo. The words "free trade" and "protectionism" have been bandied about for so long now. They are unquantified words which cannot substitute as a basis for basic policy development.

The second myth presumes that the adoption of the managed floating monetary system worldwide in 1973 introduced a smoothly functioning apparatus to redress trade imbalances and continuously to breathe life into the theory of comparative advantage.

The third myth relates to the fanciful notion that there exists an effective commercial dispute settlement mechanism in the United States and in the GATT to resolve thos disputes in a timely way, and in that connection, I would applaud your efforts, Mr. Chairman, in offering H.R. 4784 to attempt once more to pin down the basis for subsidies and antidumping activites by our trading partners.

When I lived here in Washington, I had the opportunity to be a part of the group which provided the basis for the language and thought process for titles 1 and 9 of the Trade Agreements Act of 1979. We settled at that time for achieving what we thought we could get.

As it turned out, most of us realize now that that was not anywhere nearly enough, and we should have tried harder, so I applaud your efforts, which is a step in the right direction toward refining those processes.

Myth four fantasizes that the executive branch policy development and implementing mechanism is operated with very clearly defined objectives geared to the complex world of international trade of today and is preparing for the future.

Let me concentrate first on the matter of exchange rates. There seemed to be some difference of opinion this morning, and perhaps there were other differences on other days, about whether or not there is any correlation between exchange rate fluctuations since 1973 and the flow of trade.

My own research on a nonpartisan basis indicates clearly that there is no correlation between the United States and Japan and the United States and Germany since the floating exchange rate.

Our trade balances from 1950 until 1971 were generally in surplus, and that was under a fixed exchange regime. Since 1973, we have had nothing but deficits and growing each year. When the OECD published its analysis of exchange rate changes from 1960 until 1981, I took those numbers and compared them with trade flow in terms of dollars, marks, and yen, and there is no correlation whatsoever. The floating exchange rate idea or the managed floating rate simply did not work.

There is another bit of evidence which I think should be emphasized, and that is the Federal Reserve Bank of New York study in May of 1983 in which it analyzed and evaluated all of the financial transactions which took place in this country during the month of April 1983.

It was their conclusion that not more than 4 percent, and maybe as little as 2 percent, of all of the financial transactions which take place in this country, on a day-to-day basis, are trade-related transactions.

In addition to finding managed economies challenging this country's future, we find that the financial transactions, exchange rate transactions, simply overwhelm trade-related transactions.

So even on any basis there is no way in the world that the monetary system presently in use, the managed floating system, can be trusted in the future. It has not been valuable in the past as a balancer or a mechanism to redress trade imbalances. It just won't work, and in connection with Mr. Fox's comment this morning, I believe it is essential that we find some way to differentiate between financial transactions which are in fact transactions merely to exchange, buy and sell, currencies for all kinds of reasons, attract capital to this country for all kinds of reasons, not trade related, separate out those from trade-related transactions.

That may suggest, as Chairman Butcher of the Chase Manhattan Bank suggested a year ago here in Washington, a dual exchange rate. Some European countries have such a system. As you probably remember a case was brought in 1983 under the countervailing duty and antidumping statutes relating to Poland and Czechoslovakia A dual exchange rate was found not to constitute a subsidy under our law, even though the foreign exchange rate was different from the value of the currency in Poland and in Czechoslovakia.

China's finance minister made the point that China also had a dual exchange system which he said was a sure indication of the triumph of Chinese socialism. China sells at one price and buys at another.

Regarding wage rates in China, that is interesting and important, but it really would not matter what the wage rates are in China, for example, or Korea, or many other places where they are so low because the manipulations possible under the managed floating system are so great that they can be accommodated or could be finessed and are constantly being finessed.

Mr. Butcher made a similar comment about the floating exchange rate and the 2- and 4-percent factor, and that is a crucial matter to be contended with in our own development of monetary policy.

The second point I made was that there is no effective commercial dispute settlement mechanism in the United States.

Julian Heron testified with regard to the section 301 provision and complained that the dispute settlement mechanism, the time it costs, the money it costs to put together a petition, whether it is directly to Commerce or to the International Trade Commission, is unacceptable. The timeframe is not geared to the potential permanent damage that could be induced by a delay.

It is almost as if the timeframe set for evaluation and decision is for the convenience of the Government investigators rather than for the purpose of staving off danger or damage for the individual consumer/producer.

Chairman GIBBONS. I have a hell of a time getting people convinced that there is too much time. I don't know what to do. They say they can't make the investigations.

Mr. BEDELL. In 1977, 1978, and 1979, when the trade agreement of 1979 was being developed and the statutory language was being developed, the great cry at that time was that the investigatory time could not be reduced, because there just wasn't time enough to do it, not enough bodies or enough money.

The fact of the matter is that since the 1979 act passed there has been no increase of consequence in personnel at the U.S. International Trade Commission.

Now maybe the quality of their work may have suffered from it. I have heard no complaint in that regard. I get copies all the time of all the cases and so on, but I see no particular decline in the quality of work.

On the other hand, even if it costs more money, it seems to me that the cost-effectiveness argument to protect companies in this country—and I mean protect, exactly protect—those companies from damage by trading partner companies who abuse our laws would be defensible, so I don't know really what the numbers are, but I would think that if z!1we could cut 10 to 14 months investigatory process down to a 3- to 6-month process and suffer no great increase in the budget for the International Trade Commission, that we might even be able to go further.

At least my feeling would be that the punishment must have fit the crime, and the time element is extremely crucial in any product that is related to seasonality or predatory pricing by foreign competition.

The organization of the executive branch for trade policy development, as magnificent a job as Ambassador Strauss and Ambassador Brock have done in the matter of negotiation, the mechanisms for making policy decisions, recommending them, for example, have remained the same for 20 years essentially. There have been some surface modifications, but it is the same approach.

In that 20-year period, sales have increased or international trade has risen from 6.5 to 14.25 percent of gross national product, and the dollar volume itself has multiplied more than 12 times, from $37 billion to $458 billion.

The speed of transactions has vastly increased. Trading functions have become more complex and impact now on every aspect of American life. Financial transactions overwhelm trading transactions and have skewed exchange rates which are adverse to a healthy American economy.

Nonmarket economies will continue to play a growing role, and their participation is surely to be characterized by ever increased management of commercial facilities, and yet we continue to make policy within the executive branch, for example, as if it were yesterday or 1963. That is not good enough, in my mind.

What I believe is that the suggestion, for example, that USTR and Commerce be combined is not really worthy of serious consideration. It solves nothing.

What is needed is an up-to-date White House Council for International Trade, and its function would be, for example, to use some of the most modern methods of evaluating trade flow, for example, protecting market penetration of our companies' products abroad which has never been done, so far as I know.

The Commerce Department makes some indexes of competitiveness and productivity which are worthless. They are historical documents, if they are anything. We need to begin to project some of the future trade trends, the basis on which they can be achieved, and the measures needed to capitalize on them.

In that connection, I would propose just a five-member White House Council with the final responsibility for trade decisions, and that would be headed by the USTR and include State Department, whose influence now is overwhelming anyway, Commerce, OMB, and Ag, just 5, not 11 or 13, not a deputy group, nothing, just those people to set policy and to establish some objectives and some goals for this country, because when you begin to establish goals and objectives, then you can begin to measure whether or not a given program has any prospect of being a part of the solution.

If we indulge in the use of words like mercantilism, free trade, and protectionism, it doesn't settle anything. We have projections of budgets in the Federal establishment but nothing like that in foreign trade, and yet it is 14 percent of our GNP.

None of what I have said here, though, suggests that we ought to have anything like an industrial policy. I am not suggesting that we make a troika of government, labor, and industry, and decide which industries shall live and shall not live.

If we return to a basic commercialism approach to trade and release the fetters and disincentives, which I shall mention in a minute, work over the exchange rate difficulty, there is a prospect that we could return to a more balanced or a narrower range of variations in our trade balance.

One thing that has always puzzled me. Frequently the view is taken by the macroeconomists that all that is needed to restore a trade deficit to a balanced position is to drop the dollar value.

The fact is that half or more of the deficit that we suffer from now is a structural deficit, not a monetary deficit in any shape or form, so the change in the value of the dollar will not get those companies back. There is no reason in the world why they would get them back, short of another 10- or 15-year cycle, and we have been at this trade deficit thing now for 10 years.

If there is any prospect whatever that there will be any major shift in trade deficits, short of another 10 years——

Chairman GIBBONS. You know, the big problem we have is, people don't realize that the size of our trade flow is twice as large as the defense establishment. It is three times as large as the whole housing industry in the United States—just our external trade—and we are limping along like it was 12 years ago when it was not $50 billion.

Mr. BEDELL. That is one-twelfth or one-fourteenth of the current volume of trade and still doing business at the same old store.

Chairman GIBBONS. The USTR is the same size, Customs is smaller, and we wonder why we have problems.

Mr. BEDELL. I share your concern.

Chairman GIBBONS. The President and the rest of them sit down there and don't realize how big it is, twice as big as the whole defense establishment.

Mr. BEDELL. I'm astonished. Since I bought my Apple computer 2 years ago, and since I started working and putting into it a whole range of data, plus speeches and opinions, it has become absolutely unbelievable that we continue to do things the same way.

If you look back to the 1970's and review carefully the explanations for deficits that were given by government officials, by outside economists, and by some businessmen, you would find—and I have done that—you would find one of the greatest shocks of your life.

The state of thought with regard to deficits, what they are, which combinations of which theories cause them, which combination of which theories might possibly change them, that the trade deficit of 1974 would surely be back in surplus by 1975, and surely the deficit in 1976 would be surplus in 1977, and so on, has been in disarray.

Then there is the great faith that was put in the Trade Agreements Act and the MTN's of 1979, that now because we had reduced some tariffs here and there, we would now look forward, at least beginning in 1980, to some reversal of the trend of trade deficits. I've not seen a public study yet anywhere that suggests that the MTN's, for example, had made any contribution to our trade, either for it or against it.

I applaud all the efforts, and I shed my share of blood here in Washington, but no one has yet been brave enough to go back and count what has happened in terms of trade expansion.

So my position is that we have to confront the basic realities of economic nationalism policies made by every country in the world but this country, for the most part, though we have had our share.

After World War II we were big men on campus and free trade was a good idea because all our competitors were in ruins, but the fact is that the Japanese miracle is no puzzle. It is economic nationalism, very definitely survival, and the same with much of West Europe. Now we are faced in this world with countries who manage every part of their economy.

Mr. Chairman, I published two studies, one on integrated circuitry and one on machine tools, which related to Europe, and in that I documented the entire export and subsidy programs of West Germany and France. It is a story of the interrelationship of government agencies in support of industries, and there is no way in the world that this country is going to do that, but there are other ways in which to achieve the U.S. trade objective, so I would suggest that we need the following changes.

One is a modified monetary system regimen to restrict currency fluctions affecting trade only, and within narrow limits.

Two, refinement of executive branch policy-making procedures to restrict the White House Council to the U.S. Trade Representative as chairman and include only the Secretaries of State, Commerce, Treasury, and the Director of OMB.

Three, reform the dispute settlement mechanisms in the United States to include a three-tier system geared to the time required for each to be resolved before the prospect of permanent damage emerges.

Four, the White House Council should be responsible, among other things, for forecasting international trade trends, 1, 3, and 5 years out, and refined annually and accompanied by measures contemplated to achieve those objectives in public form.

Five, encourage the accelerated bilateral agreements program and the formation—I should have said the formulation, of a more effective textile arrangement agreements program for dispute settlements. The dispute settlement mechanism in the textile arrangement has the virtue of settling disputes within a relatively small number of people within an industry and without the spotlight of great publicity, as against the GATT dispute settlement mechanism where they run off to the GATT, if and there is a problem in steel, a retaliation is authorized perhaps, or at least put into effect, on wine or so, which to me is outrageous. There needs to be a tit-for-tat intra-industry relationship in dispute areas.

Mr. JENKINS. You heard the witness on the garment workers testify on the surge of imports and the penetration in that market and he said that the bilateral agreements are not working at all in the textile field.

Mr. BEDELL. The dispute settlement mechanisms are fairly well under control, but the method by which decisions are made or not made with regard to import numbers and licenses—that whole program is a flop, no question about it at all.

I have studied those arrangements carefully, and you can make a case that there is too much discretion involved by the government in this decisionmaking activity, but it can be made to work, and that is my view. It can be made to work, if there is a will to work.

Mr. Chaikin used the words "the will of the government" on a number of occasions. That program, I think, can work if it is made to work.

Mr. JENKINS. The real difficulty in that field is that as the Big Four have 70 percent of the import or export market in the country, they can easily shift operations very quickly, and obliterate the intent of the bilateral agreements.

For that reason, that industry is, pursuing, simply from a survival standpoint, some kind of effective quota, whether it be a global quota or iron-clad bilaterals.

In view of your testimony as to the manipulation of the currency rates, particularly with a dual system, you indicated it would make no difference about the wage differential. If you did not do anything about the dual exchange rates in the manipulation of that market, can that industry survive under the present circumstances?

Mr. BEDELL. No, I would agree with Mr. Chaikin 100 percent, that it is on its way down and gone, except for modest number of companies who have a special niche in the market that others cannot replace, but as a substantial operating industry, it cannot, no.

For example, along that same line, we do not make a careful explanation for example, when we talk about market share. The International Trade Commission and others use market share as some kind of a measure, but frequently you hear the statement made that imports of steel products constitute only 22 percent of the domestic market. Then the question is asked, how can that possibly have a deleterious effect on this country?

In the critical steel pipe, steel valves, and steel fittings segment, for example, market penetration by foreign countries is on the order of 72 percent. Leaving out any national emergency problem, that in many cases is now turning out to be no business for those domestic producers who are remaining. They have no place to go, and they see no market growth possibilities for them in this country, so the business is on the verge of dying out, in addition to which, the predatory pricing ultimate weapon is now being put in place, where foreign steel valves and fittings cost more than domestics do because they have control of the market.

But on your textile matter, there is no question but they cannot survive on this basis except for a small number, and, frankly, I have no fear, and I do not think this country ought to have fear about words like "free trade," and "protectionism." You can use them against somebody and make him mad, but you don't get the job done, nor do you solve the problem.

Nationalism is still the basic driving force, but we cannot back away from saying free trade has now arrived. Adam Smith has been vindicated.

It is not true. The facts are exactly the reverse and the problem is how to deal with managed foreign currencies' operations, and their participation in not only the day-to-day decisionmaking, but also in the participation by investment, labor policy, or whatever the case may be, or any combination. That has to be acommodated in addition to the monetary matter.

Mr. Chairman, that concludes my comments.

I do applaud your call to have these hearings, because I believe there is just too much general vagueness with regard to what our objectives ought to be and what some of the problems are, and I think it has been a fine exercise in bringing some of these thoughts to fruition.

I have taken the liberty to produce back in California some specific legislative initiatives, and if you feel the need or urge to go at it——

Chairman GIBBONS. We are going to go into more of those later this year or early next year.

Mr. BEDELL. Very good.

[The prepared statement follows:]

STATEMENT OF DONALD W. BEDELL, BEDELL ASSOCIATES

SUMMARY

1. The U. S. has not played on a "level playing field in international trade since the early 1970s.

2. A major share of American trade deficits are "structural" and a substantial share of markets lost during the past 10 years will not be replaced by dollar re-valuation.

3. The urgent need to re-orient trade policy toward new commercialism cannot begin until 4 current myths forming the basis of contemporary thought are exposed as fantasies and discarded:
    a. that economic nationalism has been replaced by the Smith/Ricardo "free trade" dream.
    b. that the "managed floating" system adopted in 1973 has successfully and continuously redressed trade imbalances and should be relied on to do so in the future.
    c. that dispute settlement mechanisms in the U. S. and in the GATT satisfactorily resolve disputes in a timely way.
    d. that Executive Branch policy mechanism is effectively operated with clearly defined policy objectives geared to the complex world of today.

4. Major reforms needed for a new commercial policy include:
    a. Modified exchange rate regimen to control fluctuations with a narrow range.
    b. Expansion of bi-lateral trade agreements program, and, the formation of Textile Arrangement type agreements for dispute settlement.
    c. Revision of tax system to reduce export tax.
    d. Relaxation of anti-trust restraints on overseas operations and on domestic research and development joint ventures.
    e. Reform of dispute settlement procedures geared to prospect of permanent damage.
    f. Formation of White House Council of 5 headed by the USTR.
    g. Elimination of dis-incentives, as FCPA, anti-boycott laws and impractical regulations.
    h. Review and reform of subsidy code content in the GATT and in U. S. law to prevent abuse.

Mr. Chairman, I am pleased to have this opportunity to offer evidence that this country's industrial complex has not played on a "level playing field" in international trade since at least the early 1970s, and to suggest that the 10 year expanding trade deficit trend will be reversed in a sound way only after 4 current myths about economic and trade policy are exposed as fantasies and more fundamental commercial programs re-established.

The first myth assumes the premise that economic nationalism in the world of trade has at last magically given way to acceptance of the theories of Adam Smith and David Ricardo on a commercial level.

The second myth presumes that adoption of the "managed floating" monetary system world-wide in 1973 introduced a smoothly functioning apparatus to redress trade imbalances that continuously breathes life into the theory of "comparative advantage," in a natural way.

Myth three relates to the fanciful notion that there exists an effective commercial dispute settlement mechanism both in the U.S. and in the GATT to resolve disputes in a timely way.

Myth four fantasizes that the executive branch policy development and implementing mechanism is operated with very clearly defined objectives geared to the present complex world of international trade of today and 20 years hence.

When the perpetuation of these myths is viewed against the backdrop of the disarray in U. S. economic thought, and by an outrageous super-abundance of theories to explain deficits and surpluses, which combination of which theories cause them, whether they are good or bad and under what circumstances, it's clearly timely to return to the basics of sound commercial policy for trade.

In connection with myth #1 many still cling to the notion that "free trade" is something more than an economic idyl based on the vague dream of a Camelot-like theory of comparative advantage. Many believe it has grown to a carefully evolved righteous economic policy. History tells a far different story. As Bruce-Briggs of the Hudson Institute puts it, "No country has adopted free trade because of the plausible arguments of economic sciency; rather free trade became a policy when nations found it in their economic interests." Only when the English crushed the Dutch commercially with its "mercantilist" system did Adam Smith get the opportunity to convince the English of the "benefits" of free trade.

Three examples illustrate the folly of establishing economic guidelines based on vague unquantified slogans like "free trade," "mercantilism," or "protectionism." At best they are smokescreens hiding economic, political and historical realities.

First, no thoughtful observer is any longer puzzled by the basic ingredients of the "miracle" of Japanese recovery since World War II. Beginning in the 1950s, the applied combination of subsidies and loans to favored industries, a tax system designed to promote a high level of savings and investment, incentives offered by accelerated depreciation, tight control of interest rates, exemption from anti-trust rules, and special incentives for joint research, has been devastatingly effective. Add to this program protected home markets on a highly selective basis and lightning quick penetration of overseas markets, and a well developed Japanese work ethic, and the magic disappears.

This description is not meant to be critical. The U. S. had an enormous political stake in the economic recovery of Japan. But no basis exists to describe it as a triumph of "free trade," or a defeat for "protectionism," or vindication of "mercantilism." It was clearly a program founded on the overwhelming need to re-build a devastated country. It has been the essence of pragmatism in the face of need; the ultimate in economic nationalism.

The rebuilding of Europe after World War II serves as a second example of economic nationalism based on urgent need. Each of the countries of west Europe, history testifies, espoused "free trade" and "protectionism" and "mercantilism" with varying degrees of success and failure all during the last 300 years. In 1945 the sole economic objective was survival, and rightfully. It may be shocking to many that no new "resource allocation" occurred after 1945 based on some new "comparative economics" phenomenon. On the contrary, the OECD reports that traditional trade patterns among west European countries, and between them and their former partners abroad had by 1980 returned to their pre-World War II percentages. There was no reaching out for basing recovery on a philosophic dream, no embrace of Smith or Ricardo. In fact the language of the Treaty of Rome and the Preamble of the European Economic Community Treaty make no mention of philosophy; just the need to re-build. Economic nationalism.

As for the third major example, what of the United States? America has been hailed for adopting a free trade policy following World War II. But with its potential competitors in ruins the opportunity for enormous commercial gains became instantly clear. American industry and government seized the initiative and brought to this country unprecedented growth. It just seemed the right policy to follow; the right thing to do, under the circumstances.

In sum, the source of power and strength for all 3 major trading blocs since 1945 has clearly been self-interest. As William Safire explained recently, "Economists and businessmen who dismiss (nationalism) as a wave of the past are certain to be flattened by it." Self-interest is not served by allegiance to a theoretical model. It is related only to economic growth and prosperity as the most pragmatic measure of political success.

In the harsh realities of international trade, the crucial question for America to solve is how to refine policies and procedures to deal more effectively with the world of economic nationalism, with a world made up of managed economies and state ownership of commercial facilities, and a world in which commercial competition will grow more competitive and resourceful in large part because America's trading partners are growing ever smarter.

Determination of national priorities and objectives can only be achieved in terms of an effective balanced economy developed by the most discreet examination of all micro as well as macro factors.

This project remains to be initiated.

The second myth fantisizes that since adoption of a "managed floating" currency system in 1973 a mechanism to redress international trade balances fairly and in a timely way was in place. The record, as made clear by a comparison of the OECD exchange rate changes, 1963-1982, indicates the absence of any correlation with trade flow patterns.

For the 20 year period 1950-1970 exchange rates worldwide were generally stable. U. S. trade balances were uniformly surplus while volume of trade quadrupled to $82.7 Billion by 1970. By 1980, just 8 years after "managed floating" U. S. trade had mushroomed 5.5 times to $456 Billion, surplus had been turned into deficits of an uncontrolled nature, beginning in 1974.

The reluctance of economists and government officials to recognize the failure of the new system to redress imbalances in trade among at least major trading partners, their faith that the system would work, and their refusal to recognize that structural changes in American trade of a permanent nature were in fact taking place resulted in a public record of recommendations that can only be described as serious mis-calculations. The fact is that the relationship between exchange rate changes and trade flow patterns has been far looser and more unpredictable than most experts understood. It has been so loose in fact as not to constitute any meaningful correlation. Thus, serious mis-calculations, or a breakdown of the self-correcting mechanism, too much "intervention" by various governments, or some discreet combination of all three have conspired to place this country in the most precarious international trade position in its history.

For the record, there is attached an analysis of the world's leading currencies from 1963 to 1982 contained in OECD's Economic Outlood for July, 1983. The absence of correlation between exchange rate changes and trade patterns beginning in 1974 is startling. Yet public policy was being established in part in the late 1970s based on just such potential theoretical prospects.

Several fascinating case histories illustrate the point. By 1980, 8 years after adoption of the "managed floating" scheme, U. S. exports to Germany rose by 120%, imports from Germany rose by an impressive 85% while the Mark fell in value by 30%. In the same 8 year period, imports from Japan jumped 250% to $30 Billion, the U. S. trade deficit rose $10 Billion from $1.7 Billion to $30 Billion, and the yen fell in value by 22%. Chairman

Butcher of Chase Manhattan Bank declared in Washington in December, 1983 that "If currency values were really responding to trade patterns, the dollar would be weak and the yen strong, because Japan enjoys a massive surplus in its bilateral trade account with the U. S." He concludes with "In the face of continuing trade deficits with Japan, the dollar would have been falling in value against the yen. Instead, it's risen by 30% since 1979."

A final case involves the rise in U. S. exports to the U. K. by 376% by 1980, imports climbed by 230% without any currency fluctuation.

It's my impression that much recent academic thinking has concluded more study is needed before a new rash of projections appears. Perhaps that's reason enough to return to the basics of sound commercial policy programs to begin the process of a return to balanced trade mechanics of a simpler character.

Two final comments. A relatively obscure study by the New York Federal Reserve Bank may provide a clue to this abasence of correlation. It found that trade related financial transactions in international trade accounts for fewer than 4% of the total, perhaps as little as 2%. The volume of foreign exchange transactions, including spots, swaps, forward and futures contracts may well combine to overwhelm trade related transactions. Trade patterns become the product of financial transactions, therefore, making previous measurements of competitiveness and productivity to say nothing of pricing without significance.

The second point is that, after 10 years of deficits and shrinking overseas markets, American producers have tragically lost on a permanent basis many of those markets to foreign competitors. To some this constitutes nothing more than a substitution of numbers. If, however, those lost products and markets constitute major industrial segments vital to a thriving and productive society then sound policy development dictates a review on a micro basis the impact of these losses on the effective functioning of the entire industrial complex. Substitution analysis on a macro basis clearly ignores the basic inter-relation of industrial operations. To continue to ignore it will result in ultimate disaster.

In the third myth there is a presumption that dispute settlement procedures in the U. S. and in the GATT are geared to the needs of the petitioners. On the contrary current procedures, though improved in the 1979 Trade Agreements Act, are designed to accommodate perceived governmental administrative and legal needs at the expense of commercial equity.

With regard to Section 301 complaints, Washington attorney Julian Heron laid out the legitimate procedural defects in hearings before this subcommittee last year. Section 301 is clearly the most potent tool in the hands of the President to redress unfair trade practices employed by America's trading partners. Administrative rules imposed increase time and cost sufficiently to discourage its use. Its ineffectiveness to date may well be explained by Mr. Heron's comment that the State Department views these proceedings as "Undiplomatic and hostile actions to be pursued with maximum caution." In any case this potent statute's applicabilty has been finessed at the expense of commercial equity.

Equally ineffective and time-consuming are procedures for dispute settlement in matters involving anti-dumping, subsidized trade and Section 201 cases. Current procedures remain out of tune with the needs of commercial operations and still permit irreparable damage to domestic industry to occur before relief is obtained.

For example, the "smokestack" steel industry is admonished not to complain about a modest 22% market penetration of domestic steel market by imported products. On a macro basis such a percentage might well be acceptable under certain circumstances. But such a macro analysis hides the fact that imported steel pipe, valves and fittings hold some 72% of the domestic market. While relatively small compared to total steel those products are at the heart of this nation's vital liquid and solid processing industries such as petroleum, chemicals, natural gas, coal and water. Such dependence on imported products invites not only cartel pricing practices already under way, but blackmail threat prior to interruption of supply for unpredictable reasons out of American influence.

Another policy challenge is posed by the willingness of important domestic economic segments to consign the uneconomic steel industry to the junk pile while concentrating itself with "hi-tech" industry development. In the process abuse of the American trade laws is forgiven or excused. What's missing in this "heady" analysis is that 25% of hi-tech sales in the U. S. are made to those same "uneconomic" smokestack industries. The inter-relation of domestic industry, fundamental to the efficient functioning of a modern industrial socity, is all but forgotten and surely discarded. Such political and economic myopia are an open invitation for capital to flee the country taking jobs, profits and tax revenue with it.

Are these phenomena, and others like them,representative of sound economic policy, for consumers, investors, producers and service people alike? Only when all factors are evaluated by our leaders can wise decisions be reached.

The dispute settlement procedures in the GATT simply need overhaul. They meet the needs of petitioners even less effectively than do our own. The DISC matter, for example, has been before the GATT since 1974 without resolution and the U. S. has exercised its sovereign right to refuse GATT panel ajudication. That sign of economic nationalism will always be with us. But the settlement process has a built-in mechanism to divert, diffuse and delay settlement.

The basic flaw in these procedures stems from the fact that they are too time consuming and too costly, and, insufficient differentiation is made between the commercial needs of a seasonal agriculture commodity, a seasonal commercial product, a vast engineering and hardware project and basic industry complaints where predatory pricing and market penetration are involved. Despite the wails that can be expected from government agencies over such needed refinement, it will be remembered that in 1979 similar wails were heard when timetables were established for collecting data which were thought to be impossible to achieve. Yet, I believe the U. S. International Trade Commission still functions under the new regimen with no measurable increase in personnel. Even if there were increases, the cost/effectiveness ratio would remain very heavily in favor of commercial justice.

The fourth myth concerns the apparition of effective, modern and well co-ordinated policy authority in the Executive Branch to implement clearly defined national objectives.

The fact is that virtually no change in the structure for policy development and implementation has taken place in 20 years. Meanwhile U. S. international trade has risen from 6.5% of GNP to 14.25%, the dollar volume has multiplied 12 times from $37 Billion to $458 Billion. The speed of transactions has vastly increased, trading functions have become substantially more complex and impact now on every aspect of American life. Financial transaction now overwhelm trading transactions and have skewed exchange rates adverse to a healthy American economy. Non-market economies will continue to play a growing role and their participation is surely to be characterized by ever increased management of commercial facilities by government and exchange rate manipulation as for example the dual rates now employed by China, Poland and Czechoslovakia.

Our national leaders have yet to come to grips with the explosion in international trade both in its sheer volume and in its growing complexity.

Yet, U. S. policy continues to be operated in the same old way, by the same executive groups, and with the appearance at least of employing no new techniques with which to measure the worth to the U. S. as a whole the political, economic and social value of the decisions it makes. Basing decisions of this importance on vague concepts like "free trade" or "protectionist" does not reflect the realities of the modern world. If continued, such an approach could have disastrous consequences.

For its part, the Congress still clings to all present anti-trust statutes without serious examination of the proposition that relaxation of many might have favorable consequences in international performance without disturbing vital protection against monopoly in the U. S. It has been mesmerized by those supporting Foreign Corrupt Practices legislation, anti-boycott measures, various human rights restrictions and other impediments into believing them to be effective in raising the moral standard of the world and are free of commercial cost in terms of jobs, profits and tax revenue. The Congress has been persuaded that American business had only to wait with bated breath the return of their lost markets as soon as the "managed floating" system's self-balancing mechanism began to operate. U. S. capital did not wait with bated breath for a turnaround. Capital took flight to finance abroad productive facilities to replace domestic facilities. These changes are structural and it seems unreasonable to expect a major reversal even in 10 or 15 years of such structural changes.

As a result, U. S. producers have been faced with bitter competition at home and have lost permanently overseas markets on a broad scale. It remains to be seen if these changes are in the long term interest of the American public.

None of these comments constitutes support of any of the various versions of so-called "industrial policy," proposals. Government personnel and labor are not "risk takers" by the nature of their role-playing history. What is absolutely required at this juncture is to support "risk takers." It has been, after all, the risk takers in our society who have made the electronic industry the major industrial force it has become. Diluting that effort would be a calamity for any industry.

Hopefully these observations can be viewed as a plea to begin re-orientation of trade policy to reflect a new and bold commercialism concept. Such an approach is meant not to achieve more than restoration of America's industrial ability to produce efficiently. That ability has been seriously eroded during the past 12 years. Continuation of current approaches will permit further erosion;

a prospect unworthy of America and calculated to deny the great contribution it can make to greater production and more effective distribution of the world's wealth.

The proposed new commercialism concept is marked by a return to basic entreprenurial incentives to maximize output and by a removal of dis-incentives now in place. Specifically the concept envisions:

1. A modified monetary system regimen to restrict currency fluctuations affecting trade to move only within narrow limits.
2. Refinement of Executive Branch policy-making procedures to restrict the White House Council to the U. S. Trade Representative as chairman, and to include only the the Secretaries of State, Commerce and Treasury and the Director of OMB.
3. Reform of dispute settlement mechanisms in the U. S. to include a 3 tier system geared to the time required to each to be resolved before the prospect of permanent damage emerges. Unresolved disputes at the end of the hearing process for each tier is to be resolved within an additional 30 days by the White House Council. No dispute matter can be delayed beyond 75 days.
4. The White House Council should be responsible for forecasting international trade trends 1, 3, and 5 years out and refined annually, and accompanied by measures contemplated to achieve those objectives, in a public forum.
5. Encourage the accelerated bi-lateral agreements program and the formation of Textile Arrangement type agreements for dispute settlement results.
6. Revision of the U. S. tax system to reduce ex-

port taxes.

7. Review and tighten definitions for subsidies in U. S. trade law to prevent abuses.
8. Elimination of anti-trust restraints on American companies thereby permitting them to compete ona "level playing field" with foreign competition.
9. Relaxation of restraints on research and development joint ventures under the anti-trust laws.

Specific legislative proposals have been developed and are available upon request of the Chairman.

I applaud the Chairman's call to review international trade policy. It is urgent that a more realistic basis for forecasting and implementation of international trade be established for the long term. A re-structuring of American policy is essential to bring it to the concept of a new commercialism; imaginative, bold and free of narrow political restraints and fully responsive to the social, economic and political needs of all Americans.

I will be happy to attempt responses to any questions ny members of this subcommittee.

OECD
Economic Outlook
July, 1983

Table R15. Exchange rates, national currencies against the United States Dollar

Average of daily rates

	Monetary Unit	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
United States	Dollar	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Japan	Yen	361	362	361	362	362	361	358	358	349	308	271	292	297	297	268	210	219	227	221	249
Germany	Deutschemark	3.99	3.98	4.00	4.00	3.99	3.99	3.93	3.65	3.48	3.19	2.67	2.59	2.46	2.52	2.32	2.01	1.83	1.82	2.26	2.43
France	Franc	4.90	4.90	4.90	4.91	4.92	4.95	5.20	5.53	5.51	5.04	4.45	4.81	4.29	4.78	4.91	4.51	4.25	4.23	5.43	6.57
United Kingdom	Pound	0.36	0.36	0.36	0.36	0.36	0.42	0.42	0.42	0.41	0.40	0.41	0.43	0.45	0.56	0.57	0.52	0.47	0.43	0.50	0.57
Canada	Dollar	1.08	1.08	1.08	1.08	1.08	1.08	1.08	1.04	1.01	1.00	1.00	0.98	1.02	0.99	1.06	1.14	1.17	1.17	1.20	1.23
Italy	Lira	622	624	625	624	624	623	627	627	618	583	582	650	653	832	882	849	831	856	1 137	1 353
Australia	Dollar	0.67	0.67	0.67	0.88	0.90	0.90	0.90	0.90	0.88	0.84	0.70	0.69	0.76	0.82	0.90	0.87	0.89	0.88	0.87	0.99
New Zealand	Dollar	0.72	0.72	0.72	0.72	0.74	0.90	0.90	0.90	0.88	0.84	0.73	0.71	0.83	1.00	1.03	0.96	0.98	1.03	1.15	1.33
Austria	Schilling	25.85	25.84	25.84	25.85	25.85	25.86	25.87	25.87	24.91	23.12	19.59	18.69	17.42	17.94	16.52	14.53	13.37	12.94	15.92	17.01
Belgium-Luxembourg	Franc	49.87	49.75	49.64	49.83	49.69	49.94	50.14	49.66	48.59	44.01	38.96	38.96	36.79	38.61	35.84	31.50	29.31	29.25	37.14	45.70
Denmark	Krone	6.90	6.92	6.92	6.91	6.99	7.48	7.52	7.50	7.41	6.98	6.03	6.09	5.74	6.04	6.00	5.51	5.26	5.64	7.12	8.33
Finland	Markka	3.22	3.22	3.22	3.22	3.43	4.21	4.21	4.21	4.21	4.16	3.82	3.76	3.67	3.86	4.02	4.11	3.89	3.72	4.30	4.81
Greece	Drachma	30.00	30.00	30.00	30.00	30.00	30.00	30.00	30.00	30.00	30.00	29.64	30.00	32.02	36.52	36.83	36.73	37.04	42.64	55.34	66.65
Iceland	Krona	0.43	0.43	0.43	0.43	0.44	0.61	0.88	0.88	0.88	0.88	0.92	0.99	1.53	1.82	1.99	2.71	3.53	4.80	7.21	12.30
Ireland	Pound	0.36	0.36	0.36	0.36	0.36	0.42	0.42	0.42	0.41	0.40	0.41	0.43	0.45	0.56	0.57	0.52	0.49	0.49	0.62	0.70
Netherlands	Guilder	3.60	3.61	3.60	3.62	3.60	3.62	3.62	3.62	3.50	3.21	2.79	2.69	2.53	2.64	2.45	2.16	2.01	1.99	2.50	2.67
Norway	Krone	7.15	7.16	7.15	7.15	7.15	7.14	7.14	7.15	7.04	6.59	5.74	5.52	5.22	5.46	5.32	5.24	5.06	4.94	5.73	6.45
Portugal	Escudo	28.66	28.74	28.71	28.72	28.75	28.68	28.56	28.59	28.21	27.01	24.37	25.24	25.48	30.15	38.23	43.92	48.90	50.00	61.53	79.40
Spain	Peseta	60.01	60.01	60.03	60.06	61.21	70.07	70.10	70.03	69.53	64.29	58.16	57.64	57.40	66.93	76.01	76.70	67.15	71.72	92.26	109.80
Sweden	Krona	5.19	5.15	5.16	5.19	5.16	5.17	5.17	5.19	5.11	4.76	4.35	4.43	4.15	4.36	4.48	4.52	4.29	4.23	5.06	6.28
Switzerland	Franc	4.32	4.32	4.33	4.33	4.33	4.32	4.31	4.31	4.12	3.82	3.17	2.98	2.58	2.50	2.40	1.79	1.66	1.68	1.97	2.03
Turkey	Lira	9.02	9.04	9.04	9.04	9.04	9.04	9.04	11.49	14.86	14.15	14.00	14.00	14.30	15.78	17.83	24.04	37.53	76.04	110.16	160.75

Table R16. Effective exchange rates

Indices 1970 Q1 = 100, average of daily rates

	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
United States	100.3	100.4	99.2	96.7	90.8	83.6	84.6	84.0	87.6	87.0	79.2	77.1	77.1	87.0	96.0
Japan	99.4	100.2	99.6	101.0	110.6	118.5	110.4	107.5	112.0	124.1	151.3	140.0	134.7	153.5	144.7
Germany	90.6	93.1	100.9	104.1	106.6	116.4	121.6	122.3	127.6	136.4	142.2	148.3	149.3	142.8	148.3
France	114.2	108.8	100.1	97.9	99.9	101.8	94.4	102.3	97.3	91.0	87.8	87.5	87.9	82.2	74.9
United Kingdom	99.5	99.7	99.5	99.6	96.1	85.2	81.8	75.4	64.4	61.3	61.4	65.5	71.3	72.2	68.6
Canada	99.8	99.9	102.8	105.2	104.0	98.6	102.1	97.7	103.9	94.9	82.8	79.2	79.2	81.7	83.6
Italy	101.1	100.9	100.1	99.3	98.4	87.6	78.5	74.6	61.6	56.0	51.8	49.8	48.2	43.4	40.0
Australia	99.9	99.7	99.5	99.6	97.9	107.4	112.2	102.5	100.2	87.4	79.1	76.3	78.4	84.9	82.5
New Zealand	99.6	99.7	99.6	100.0	99.8	106.8	113.0	98.4	86.8	83.9	81.0	77.1	72.3	71.1	67.0
Austria	101.1	101.1	99.7	101.0	102.0	108.5	113.8	116.8	119.7	126.4	126.4	129.2	133.1	129.2	131.8
Belgium-Luxembourg	99.0	99.3	99.7	99.5	102.2	102.6	103.3	104.0	105.2	109.7	11.7	112.3	111.9	107.4	96.0
Denmark	100.5	100.4	99.8	99.0	99.3	105.4	105.3	108.4	110.0	109.2	109.1	107.9	99.1	92.4	88.0
Finland	100.4	100.7	99.9	97.8	93.2	92.6	94.9	94.3	96.0	90.8	81.4	81.1	83.7	85.7	86.4
Greece	100.5	100.8	99.7	97.5	91.2	83.1	83.0	75.1	69.8	67.1	60.4	56.6	49.1	45.1	41.2
Iceland	147.9	100.6	99.9	98.5	94.2	83.1	79.3	49.6	43.8	40.0	27.4	19.9	14.8	11.2	7.3
Ireland	99.7	99.8	99.6	99.6	97.7	91.6	89.5	85.1	77.1	74.6	74.9	74.9	72.6	66.0	65.1
Netherlands	101.4	101.6	100.2	101.1	102.4	104.9	109.8	111.6	113.4	117.8	119.0	119.9	120.3	116.9	122.0
Norway	100.4	100.7	99.9	99.4	100.4	105.8	111.2	114.5	117.5	119.0	110.9	108.3	110.3	112.9	112.9
Portugal	99.4	100.1	99.5	98.4	97.9	101.0	98.7	95.4	86.7	67.8	53.5	45.3	43.7	41.6	36.1
Spain	99.7	100.2	100.0	98.9	100.9	101.7	104.1	101.2	92.4	80.8	72.1	78.4	73.1	66.6	61.6
Sweden	100.5	100.8	99.7	99.3	100.6	99.9	98.6	102.0	103.5	99.2	89.1	88.7	89.2	88.6	79.3
Switzerland	99.9	100.3	99.7	102.5	103.6	113.3	122.4	136.6	151.0	154.1	189.0	191.6	189.1	191.6	205.9
Turkey	100.8	100.9	83.3	59.1	58.2	87.7	88.1	82.6	78.7	67.6	44.4	29.2	13.3	10.8	8.0

Chairman GIBBONS. I wish to thank all of the witnesses today and all of the witnesses we have heard so far.

Our next meeting will be on April 25 at 9:30 a.m. in room 1100 of the Longworth Building.

On that day, we will hear from Members of Congress and from Governors on how the deficit is affecting firms and workers in their States and districts, and what their proposed remedies are.

Thank you very much.

[Whereupon, at 3:10 p.m., the subcommittee adjourned, to reconvene at 9:30 a.m., Wednesday, April 25, 1984.]

U.S. TRADE DEFICIT

WEDNESDAY, APRIL 25, 1984

House of Representatives,
Committee on Ways and Means,
Subcommittee on Trade,
Washington, DC.

The subcommittee met at 9:35 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Sam M. Gibbons (chairman of the subcommittee) presiding.

Chairman Gibbons. The meeting will come to order.

Today we will hear testimony from witnesses in our hearings on the causes and implications of the U.S. trade deficit. We have saved the best witnesses for last. Today we will hear from Members of Congress who are knowledgeable in this field. Mr. Cooper Evans of Iowa and Mr. Richard Ottinger of New York, who were originally scheduled to testify in person, are unable to be here today. However, they will submit statements for the record as will a number of other Members.

Those statements and the testimony of all other witnesses who appear before us will be included in the report which we hope to issue in the near future. In the report we will outline the major conclusions of our witnesses and make recommendations which seem appropriate to deal with the trade deficit.

I would like to welcome our first witness, Senator Max Baucus of Montana, of course who is not a stranger to any of us, because of his distinguished service in the Senate and his fine and distinguished service prior to that in the House. We appreciate you coming here, Senator. We will be happy to hear you.

STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM THE STATE OF MONTANA

Senator Baucus. Thank you very much, Mr. Chairman. I have a statement which I would like to have included in the record.

Chairman Gibbons. Yes, sir, it will be included.

Senator Baucus. I will summarize it at this point.

Mr. Chairman, first I want to compliment you for holding these hearings. The graphs over on the side dramatically illustrate our trade deficit lost jobs, and the devastating effect it has on our economy. All American industries and States are very dramatically affected by the trade deficit. The fact of the matter is, about 70 percent of all products produced in the United States today are in one form or another in international competition. And the international marketplace is changing at a faster rate and more significantly than most Americans fully understand.

Your hearings help inform the American people about trade, so that we can begin to decide exactly what is happening and what we should do about it.

Our basic assumption is that we should have the fairest and freest trade possible, in order to help all our economies to the greatest possible extent.

I am here, Mr. Chairman, to encourage you in that endeavor, and also to give my views on two points which I think will improve our overall trade policy.

First, we must reduce the giant Federal budget deficit, which significantly inflates the value of the dollar and exacerbates the trade deficit. That certainly hurts us in my State of Montana.

For example, today a bushel of wheat sells for about the same $3.40 a bushel it sold for in 1980. The difference is that, whereas Australians sold their wheat in 1980 for $3.40 a bushel, the Australian dollar is so undervalued compared with the American dollar that Australian wheat producers now are getting a $1 price advantage per bushel, when they compete with American farmers.

There are lots of examples like that, and it just indicates how much we have to work to get the dollar more in line with other countries' currencies, so that our exporters can get a fair deal.

That, of course requires lower interest rates and lower deficits.

In this respect, Mr. Chairman, I know that you and the Ways and Means and Senate Finance Committees have taken a major first step to try to get these deficits down, with the tax bills that have come out of both committees. I worked hard to help pass the Finance Committee bill. But we must go even further.

I frankly do not believe that either of the major proposals, the one in the House and the one in the Senate, go quite far enough to get deficits down, particularly on the spending side.

That's why I personally am joining with Senator Kassebaum of Kansas, Senator Biden from Delaware, and Senator Grassley from Iowa, to propose a 1-year spending freeze, in 1985, as a first step to try to get control of our Federal spending. I hope that our proposal begins to gain some momentum in the House as well, but I can say that it almost passed the Senate Budget Committee a couple of weeks ago.

The chief sponsor, Senator Kassebaum, only withdrew the proposal when a couple of Senators who originally were going to vote for it got cold feet and changed their minds at the last minute. However, the fact that the proposal almost passed shows there is a lot of interest in doing something more dramatic than we have done thus far.

Second, Mr. Chairman, we should be a little tougher with our trading partners. I am very much a freetrader. I believe that the United States and the entire world generally are better off the more countries do not erect trade barriers. But I must say that comparative advantage is not necessarily God-given.

Especially lately, it tends to be man-made. That is, with the barriers to trade that some countries erect, and with the subsidies that some countries create, comparative advantage begins to lose meaning.

Let me describe one experience I have had, which reinforces my personal feeling that we should get a little tougher. That experience relates to Japan's quota on beef. Mr. Chairman, I know you understand Japan's barriers, for example, the barriers Japan imposes against Florida and other citrus States. We don't have many oranges in the northern part of the country but we do have some cattle. I followed the negotiations over Japan's barriers against beef imports very closely and worked very hard to help our negotiators. Let me say this: It is clear to me that the agreement we got with Japan is a better agreement than we otherwise would have, because the Congress, our industry, and our trade negotiators got tough. Let me explain a little more fully.

As you know, the beef agreement which expired last March 31, basically provided that 30,800 tons of American beef could be imported into Japan each year. There are 120 million people in Japan; 3,800 tons translates to about one 6-ounce steak per Japanese citizen per year. As you know, quotas are GATT illegal unless superseded by bilateral agreements.

In this case there was a bilateral agreement between the United States and Japan. Sixty percent of our American beef goes to Japan. Japan is a big market, and in the fifties Japan did not have a quota, and much more American been entered Japan. But in order to protect the Japanese beef industry, Japan enacted a very strict quota. That is one reason why we now ship less beef to Japan than we had in earlier years.

During the last year I have done what I can do to strengthen the hand of the American trade negotiators, Ambassador Brock, Deputy Don Nelson, and Mike Smith. I can tell you that our joint efforts worked, to some degree. What did we do?

Well, in the first place, I made it very clear to the Japanese people, to Prime Minister Nakasone, and to President Reagan, that if Japan did not significantly increase the quota, I would do what I could to organize Senators to vote in favor of domestic content legislation. I am not in favor of domestic content legislation. I think it is a bad idea. Nevertheless I think that we needed to get a message to Japan.

I don't know whether this "linkage" turned the tide, but I think it was significant.

In addition, we dramatized the issue. We invited many Montana stock growers to the Mike Mansfield Room in the Capitol, and brought back 100 pounds of Montana beef and had a beef barbeque for Ambassador Okawara and the Japanese Embassy. There were lots of photos and television films transmitted back to Tokyo, so the Japanese saw what we were doing.

In addition, our effort was heavily covered in Japanese newspapers. I don't read Japanese, but I know that we got high visibility in Japan for our efforts. I know that helped to a considerable degree.

Well, as negotiations proceeded, Japan continued stonewalling. Mike Smith flew over to Tokyo many times and his Japanese counterparts came over here many times—but nothing happened. The Japanese were not agreeing to anything.

During this time, I received a couple of letters from American businessmen in Tokyo saying: Senator, you are right on. The Japanese are very courteous, they are very decent and wonderful people, but the only language they really understand is power. You have got to be tough with them.

I am not singling out the Japanese. I am not singling out any country. But I do think that that letter, in my experience, bears a lot of truth.

As the final days and literally the final hours of the old beef agreement concluded, we finally began to see some movement. And at the same time, Mr. Chairman, I indicated to Prime Minister Nakasone and to the Japanese Ambassador that I would encourage the National Cattlemen's Association to file a section 301 proceeding under GATT if Japan did not agree.

In addition, we found another provision in the law which essentially gives the President the authority to suspend investment tax credits on any business property produced in a country which is violating international trade laws; we made it clear we were going to pursue that remedy. I also reemphasized that I would organize efforts to support domestic content legislation in the Senate.

I am not saying that these made the difference, but I do think they made some difference. Ambassador Mike Mansfield, our Ambassador to Japan, wrote me about 2 months ago, saying he didn't think that Japan would agree to more than a 5,000-ton annual increase. It turned out they agreed to almost a 7,000 annual increase. By pooling all of our efforts, we were somewhat successful.

I might add, Mr. Chairman, that we also did not allow our industries to be divided and conquered by the Japanese trade negotiators. The Japanese negotiators expressly told American wheat farmers, "We are going to buy less American wheat if you are too tough on beef." That intimidated some American wheat producers for a while, but by hanging together as a country, industry joining industry, we made it clear that we were not going to let them divide and conquer.

I think that the same lessons can be learned with other American industries. The telecommunications industry, for example, that wants to export products into Japan, should not be divided either.

In conclusion, let me just say a lesson I have learned is that you have got to stand up for your rights. You have got to be tough. The Japanese knew we were right. I have talked to many Japanese people, and they knew that they should have opened up those quotas very significantly.

I have talked to members of the Japanese Parliament who represent Tokyo constituencies in the cities, who said: You bet, we would love to have a lot more beef.

I have talked to MITI representatives who indicated, yes, it is wrong the degree to which Japan subsidizes agriculture. Also, as you probably kow,. Mr. Chairman, Keidanren, the major business group in Japan, has said very clearly that Japan's subsidization of agriculture is improper and inefficient. Of course, they want the subsidy for their growing and developing industries, like electronics and microprocessing.

We took advantage, too, of the sentiment in Japan that they knew that the quota was wrong and they should raise it. That is not true with the Japanese cattle growers but the bulk of the Japanese understood that it should be increased.

Let me finally conclude, Mr. Chairman, by again thanking you for holding these hearings and encouraging us to work together. I might compliment you, too, on your trade remedies reform bill, which I think will begin to reach some upstream subsidies that some countries enact. I think all of this is helpful.

[The prepared statement follows:]

STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM THE STATE OF MONTANA

INTRODUCTION

Thank you, Mr. Chairman.

At the outset I want to commend you and your Subcommittee for holding these hearings and underscoring the serious problem our trade deficit represents. I also want to compliment you on your leadership in the area of trade policy.

Today I'd like to share a few lessons I've learned during a trade battle I've waged over the past year, over U.S. sales of beef to Japan.

TRADE: A TOP PRIORITY

Trade issues are more important than ever before.

Seventy percent of American products now face international competition. As a result, our economy really is the world economy. Jobs in Butte depend on the government policy of Zambia and consumer spending patterns in Taiwan.

How have we adjusted to international competition?

Well, the figures don't look good.

At the rate we're going, in 1984, our annual trade deficit will exceed $100 billion.

What does this mean?

First and foremost, it means U.S. companies are losing sales, at home and abroad. And this means that U.S. workers are losing more than 3 million jobs.

AMERICA'S RESPONSE

How can we recapture these lost sales and lost jobs?

First, we must excel. Our managers must be the sharpest. Our workers must be the best.

But let us not kid ourselves. In today's fierce international marketplace, building a better mousetrap is not enough.

You can excel through your own creativity, economy, and hard work. You can make the best product at a fair price.

But, whether you are a steel producer in Pittsburgh, a cattleman in Montana, or a high tech manufacturer in Silicon Valley, you won't be able to compete if your price is inflated in the world market by an overvalued dollar, and if your products are blocked at the dock by unfair trade barriers.

So, to really compete, we must tighten up our trade policy. Among other things, this means reducing the budget deficit and taking a tougher position in international trade negotiations.

REDUCING THE BUDGET DEFICIT

Let me briefly discuss the federal budget deficit first, because it is our major trade problem.

The budget deficit is increasing by $22 million an hour. It's keeping interest rates high. And that's keeping the dollar overvalued.

This cuts us with a two edged sword.

On the one hand, American businesses see their export prices artificially rise, pricing them out of many markets abroad. For example, it costs about the same to produce a pound of Montana beef as it does to produce a pound of Australian beef. But, because of the inflated value of the dollar, the Australian beef has an automatic 25 percent price advantage.

On the other hand, American businesses see their domestic markets undercut by foreign importers that enjoy an automatic price subsidy because of the overvalued dollar.

Finally, we may be working out the beginning of the solution. Both the Ways and Means Committee and the Senate Finance Committee have put together solid bills that make down-payments on the deficit.

But we must do more. That's why I'm supporting a spending freeze that would save an additional $30 billion next year. I know that a freeze is strong medicine. But I think we need strong medicine to reduce the budget deficit.

BREAKING DOWN TRADE BARRIERS

I also think we need to break down foreign trade barriers.

Take the case of Japan.

The figures are striking. In 1983, we sold Japan $21.9 billion worth of goods. They sold *us* almost twice as much. As a result, we had a $19.3 billion bilateral trade deficit.

There are many reasons for this deficit. One of the main ones is Japan's barriers against imports of U.S. products.

The U.S. provides broad access to the goods Japan produces competitively. But Japan does not reciprocate. It maintains high barriers that block many of the agricultural, communications, and high-tech products that we could sell competitively in Japan.

When Americans complain about this, the Japanese protest that they have the lowest tariffs of any industrialized country in the world.

Technically, that's correct. But if we look closer at the Japanese system, we see that there's a lot more to the story.

It's easy for the Japanese to eliminate their tariffs on televisions, pocket calculators, and small cars. They don't face much foreign competition.

But try to get them to reduce their barriers when they do face foreign competition. For example, try to get them to reduce their barriers against beef, timber, citrus, or high speed communications imports.

When that happens, they retreat to protectionism every time, arguing that they must remain self-sufficient and that powerful domestic political forces prevent them from making substantial concessions.

How should we respond?

Well, we shouldn't retreat into wholesale protectionism. That would hurt our exporters, hurt our consumers, and, in the long run, make our overall economy less efficient.

What we should do is assert our rights much more aggressively.

THE CASE OF JAPANESE BEEF

In recent months we may have started to do just that. And that is why I thought it would be useful to discuss the case of the U.S.-Japanese negotiations over beef sales, and how these negotiations may have set a new tone in U.S.-Japanese trade relations.

The beef industry is Montana's second most important industry. We'd like to export as much beef as possible. And the most obvious export market is Japan, where income is rising and consumers have shown a clear preference for U.S. beef.

But Japan maintains a quota system that severly restricts beef imports. And it maintains a web of other barriers that quintuple the price of whatever beef makes it past the quota.

In 1979, the U.S. and Japan negotiated a 5-year beef agreement. Under this agreement, Japan agreed to increase the quota to 30,800 tons a year—still less than one good sirloin steak per Japanese consumer.

The agreement was scheduled to expire April 1st. For months before that, U.S. and Japanese negotiators tried to reach a new agreement.

At first, the U.S. negotiators asked that the quota system be dismantled. The Japanese negotiators, in turn, refused to offer more than a token increase.

After rounds of talks, our negotiators proposed that the quota be increased by only about 10,000 pounds a year—meeting the Japanese more than halfway.

But the Japanese negotiators still refused to offer more than a token increase.

In my opinion, they expected us to eventually capitulate, like we usually do.

But this time, we surprised them. We didn't accept Japan's token increase. Instead, we let the old agreement expire without being replaced.

Two days later, the Finance Committee held a hearing at which everyone—our U.S. trade negotiators, cattlemen's groups, and several Senators—agreed that the U.S. should stand firm and should file a GATT complaint against Japan and consider further forms of retaliation.

In the face of this pressure, the Japanese finally came around. They agreed to increase the quota by 6,900 tons a year for four years and to reduce some of the other nontariff barriers.

Although not entirely satisfactory, this new beef agreement represents a significant step in the right direction.

What's more, the beef negotiations can teach us two important lessons.

First, it pays to hang tough. Even if it means enduring the tension and uneasiness hard bargaining sometimes creates. Only after the initial beef negotiations broke down, and it became clear that the Administration would file a GATT complaint and consider further retaliation, did the Japanese begin making serious offers.

Second, as a nation we must get behind all our industries. Our economy is so diverse that it's easy for other countries to play the "divide and conquer" game. We must guard against this.

For example, Japanese negotiators frequently warn U.S. negotiators that, if the U.S. takes a tough negotiating position on "politically sensitive" issues like agriculture, the Japanese won't be able to make concessions in other areas, like telecommunications, where more trade is involved. Then they get the other affected industries to complain that America's negotiating position is too tough and may adversely affect them.

Unfortunately, in the past U.S. negotiators have responded to this domestic pressure and softened their position, only to find later that the implied Japanese concessions were not forthcoming.

But during the beef negotiations, this didn't happen.

We didn't relent. We hung tough. Not because the beef issue is our most important bilateral trade issue. It's not.

But we hung tough because we were standing up against an unfair trade practice—and we were right.

What's more, the Japanese knew we were right and I bet they respect us more for having stood up for ourselves.

This, Mr. Chairman, is the right approach. We've got to put our trading partners on notice that we stand for fair trade—and, equally important, that we are willing to fight for it.

The successful resolution of issues like the beef issue will breed the successful resolution of other issues like the telecommunications and capital markets issues.

Ultimately, all American industries will benefit from a trade policy that's tough across-the-board.

CONCLUSION

Mr. Chairman, let me conclude by commending you again for holding this important series of hearings and by reiterating my basic message:

We've got to get tougher.

We've got to get tougher on ourselves—by getting our own federal budget deficit under control.

And we've got to get tougher on our trading partners—by letting them know we will no longer tolerate their unfair trading practices.

We should show the kind of toughness and determination that we showed in the Japanese beef negotiations.

By doing so, we can increase American sales and increase American jobs, without resorting to counterproductive protectionism.

Thank you.

Chairman **Gibbons**. Thank you, Senator. We hope to have that bill over in the Senate in a couple of weeks. Perhaps you all can make some improvements on it. We would like to see what can be done this year in this matter. That is a rather limited bill, really confined to two subject matters—dumping and subsidies, what we call the unfair trade practices.

The way you dramatize the problem with the Japanese I think is very interesting. We unfortunately seem to have to raise our voices, when we are used to negotiating more on the basis of what is fair, and what is just, and what is equitable, and what is the law. I regret to say that sometimes what you say is true—you have got to get people's attention and bargain hard like that. So I commend you for the success you have had.

Let me look at this problem in the long range. As you know, Florida is also a big citrus producer, and we are always interested in markets in Japan. The Japanese have come to us and said, we have been hungry a number of times in the past. It does us no good just to buy America's surplus, if they are not going to be a reliable supplier, as they turned out not to have been in the soybean era. We put our people in great jeopardy by that.

Have you, in working in the agriculture area more than I have ever thought about any long-term agreements to provide at least minimum amounts of food to countries like Japan? Their history, they stress, is that they nearly starved to death twice in this century; if we are just going to sell them our surplus food supplies and withdraw our sales every time they need food also, they will find themselves starving again. That is not a very enticing position for a leader to put his people in. So I can understand their resistance to some of these import liberalizing items and some of the rather wasteful subsidy practices that it forces upon them.

I have looked at their farming, and while I know little about farming, I can say it has to be very inefficient because of the scale on which it is conducted. Elaborate on that, if you will.

Senator BAUCUS. Thank you, Mr. Chairman. I think there is a lot of value in working toward longer term agreements with many countries, particularly in supplying agricultural products. It seems to me that with the agricultural surplus we have in America, we should be able to devote it to good use. But it further seems to me that most other countries in the world can be divided into three categories: One, the industrialized countries like Japan and Europe, who have the means to purchase American products, but who have very strong protectionist forces in those countries that want to produce as much food for themselves as they possibly can. Japan, for example, imports about 50 percent of the food it consumes. That puts it in a very precarious position, and they therefore highly subsidize their agricultural producers, rice as well as cattle.

For another example, I understand that Saudi Arabia subsidizes its wheat production by about $24 a bushel. They can afford it, of course, but still they want to produce their own wheat.

The second tier of countries, it seems to me, are the middle tier, the Mexicos of the world, who have some means to buy our products, not quite as much as first-tier countries but some, and who are hungry so they are more inclined to buy.

The third tier is the very poor countries who really don't have the wherewithal to purchase our goods. Those are countries, it seems to me, where we should expand our Food for Peace programs and other kinds of programs, just to give the food basically to those countries.

In the first two categories of countries, it seems to me that longer term agreements would go a long way to alleviate concerns about whether we are a reliable supplier.

The soybean incident comes back to haunt us many, many times, and the grain embargo to the Soviet Union too comes back, and that is often cited as another example that the United States is not a reliable supplier.

I hope that we have learned some of those lessons. I think long-term agreements, while not appropriate in every instance, certainly can be used more fully than we have thus far.

Chairman GIBBONS. It just would seem to me that in the beef industry, there is no doubt that with Japan's very limited grazing land and the high prices of imported grains, if we could sell into their market all the beef that they wanted or needed, there would be no Japanese beef industry left.

Senator BAUCUS. That is right.

Chairman GIBBONS. It takes a pretty brave leader to say: I am going to dismantle an industry. People have got to eat three times a day—at least most of us feel like we need to—7 days a week all year long. I would assume it would take quite some time to rebuild the beef industry, if a world shortage of beef developed, and you are only able to buy people's surpluses.

We are fortunate in America that has never happened to us, and God knows I hope it never does. But it seems to me that in selling things like beef, grains, and even citrus around the world, we are going to have to make long-term agreements not only to sell our surplus but also to be a supplier that is reliable. Some industries are going to have to completely dismantle in order to take them out.

Senator BAUCUS. I think that is true—what's more longer term agreements would reduce some of the fluctuations in price.

Chairman GIBBONS. Yes.

Senator BAUCUS. Price and quantity both. All of us look for a little more stability, to satisfy expectations. Longer-term agreements would reduce the peaks and the valleys.

Chairman GIBBONS. I want to express my personal appreciation for your coming here and testifying today. It has been very helpful. You have brought us new material and you reaffirmed some of the things that we have reached some tentative decisions on.

I hope that you will tell your colleagues that you were warmly greeted over here, because we have got so many bills pending over in the Senate now we would like to get some action on. I realize that you are a Democrat and you don't control the schedule over there, but we would appreciate any little prayerful words you can help us with.

Senator BAUCUS. Mr. Chairman, we hope next year we will be able to control the schedule a little bit better.

Chairman GIBBONS. Well, I hope so too, but we have had some bills over there now for almost a year and a half. I know you all have been busy. I watch the lights on in the Capitol at night. This is more of a gentleman's club over here, I am afraid, as far as the working schedule is concerned than is the Senate. We would appreciate some help.

Senator BAUCUS. Thank you, Mr. Chairman.

Chairman GIBBONS. Mr. Schulze, do you have questions?

Mr. SCHULZE. Other than to thank our colleagues, Mr. Chairman, I have no questions.

Chairman GIBBONS. Thank you, Senator.

Our next witness is Mr. Zschau, our colleague. Won't you come forward, please, sir, a Member of Congress from California.

I ran into one of our ex-California colleagues this morning and he gave me some avocado pears which I am going to take home and put on the windowsill to ripen.

Glad to have you here.

STATEMENT OF HON. ED ZSCHAU, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. ZSCHAU. If you can't export them the next best thing to do is to give them away to your former colleagues.

Chairman GIBBONS. We grow some of those things in Florida, too. They are mighty good.

Go right ahead, please.

Mr. ZSCHAU. Good morning, Mr. Chairman. I want to thank you for the opportunity to appear before your subcommittee. I also want to take this opportunity to commend you and the subcommittee for holding these hearings on the burgeoning trade deficit. It is a serious problem. It is a problem that is costing American jobs. These hearings that you are holding are not only shedding light on the problem itself and making sure that we are putting attention on it, but are also indicating some of the causes of the problem and potential solutions.

I would like to very briefly this morning, Mr. Chairman, comment on just one aspect of this growing trade deficit that I find particularly distressing.

As you know, I represent an area of California called Silicon Valley. You may have read in the Wall Street Journal recently that Silicon Valley is soon to be the subject for a new soap opera that promises to tell in great detail the story of technology and lust. Even though we have had a good history in technology, I don't think we are even competitive when it comes to lust in this country.

Where we have been competitive is in electronics products. There are several hundred electronics companies in my district. Many of them are small companies, but they have had an outstanding trade record in the past.

Recently, I came across some information that has been prepared by the International Trade Administration in the Department of Commerce. It talks about the history of electronics balance of trade. We used to point to this as one of the bright spots in our trade picture because, in contrast to some other industries, electronics products have been running rather substantial trade surpluses in the past.

But the current data is very distressing.

In 1980 the total trade surplus for electronics products was $7.4 billion. In 1983, last year, it was $1.46 billion and there are many people who expect it to go negative in this coming year, 1984. This bright spot which we have had in trade may turn out to be another example of a trade deficit.

What has caused it?

Well, the growth of exports has been rather slow worldwide, and there has been a rapid growth in imports, but if you look at it further, most of the reduction in this trade surplus has come about because of an increasing trade deficit with Japan. Over the same period of time, 1980 to 1983, the trade deficit with Japan increased by $5 billion from $3.9 billion to $8.8 billion deficit.

The total electronics products trade surplus went down by $6 billion, so five-sixths of the decrease in our trade surplus has come about from an increase in the trade deficit with Japan.

What are the causes for this? Well, it is easy to say Government policies—both that in the United States and those of our trading competitors—are to blame, and I think to a large extent that may be true, but I think also that American management has to share some of the responsibility.

I was for 13 years the president of a high technology company and I know how easy it is to be lulled by the massive homogenous market that we have here in the United States and how hard it is sometimes, particularly for small companies, to become export-oriented. I think that there is a fundamental in this modern world that American managers as well as Government have to now understand: If we are not competitive in foreign markets, we are not going to be competitive here at home.

It is no longer satisfactory to focus just on the domestic market. We have to look at our international markets and find ways to be competitive abroad as well. That means marketing, understanding the special needs abroad, manufacturing, so that we can keep our costs down and our quality high, so that we can be competitive throughout the whole world.

In addition to American business becoming more export-oriented, there are Government actions that I believe can enhance our competitiveness.

I don't subscribe to those views of people who say that what we need is some sort of a high technology or industrial planning board to target on specific technologies of industries and fund them with taxpayer dollars, but I do subscribe to a targeting of a different kind.

It is the targeting by Government on the process by which new technologies and new industries develop and grow, the process of innovation; that is creating in this country an environment in which new ideas and new technologies are likely to flourish.

I feel that targeting on the process of innovation means rationalizing the plethora of our Government policies, R&D policy, tax policy, regulatory policy, trade policy, education policy, to make sure that the prerequisites for an environment for innovation are enhanced.

The prerequisites are: A strong R&D commitment in this country; an environment for risk taking by investors and entrepreneurs and companies; an education system that trains enough technical people as well as management people, people who can deal with the challenges of the modern world; and expanding market opportunities, which really means a healthy domestic economy and aggressive trade policies.

Fortunately there are a number of pieces of legislation that are coming through this committee, that have come through this committee and others here in the House, and also in the other body, that are dealing with these prerequisites.

For example, the House Judiciary Committee recently passed out a bill to modify our antitrust laws so that corporations could form research and development joint ventures, and share their scarce research resources in order to pursue risky and perhaps expensive projects to enable them to make technical breakthroughs.

There has been passed in 1981 the R&D tax credit, which has encouraged more research and development spending. There are other proposals, patent policy proposals that are wending their way through Congress, so I think that the Congress in general is taking action along these lines to enhance the environment for innovation, but it also I think has to focus very specifically on the trade policy in order to deal with this trade deficit issue.

That means tough negotiations with our trading competitors in order to break down the trade barriers that have long existed in other countries. It means enforcement of our trade agreements. It means maintaining export incentives.

We have had for many years—in fact my company was motivated quite highly by—the Domestic International Sales Corp. that enabled companies to postpone the payment of taxes on export sales. We in this country have agreed to discontinue that, but we need to come up with a substitute that enables companies, and particularly small companies, to have extra incentives for exporting abroad.

I think most importantly at this time we have to make sure that our export controls that are instituted under the Export Administration Act are focused on those technologies that are truly militarily critical, and that the procedures by which we institute those controls are streamlined so that we don't provide obstacles to exporting companies.

Let me just give you one specific example. With great difficulty the industrial laser companies which make the lasers that are used in machine tools were able to penetrate the Japanese market. Japan, noticing that this was an attractive market, assisted through subsidies Japanese companies to develop competitive products.

At the very time that Hitachi and Mitubishi are coming forward with competitive products, the export controls on the shipment of industrial lasers from the United States to Japan are being tightened in the name of national security. That is making it more difficult for the U.S. companies to compete in the Japanese market against competitors that are being strengthened over there.

Finally, in addition to the tough trade negotiations and enforcement, export incentives, focused and efficient export controls, the exchange rates between the dollar, the yen and the other currencies have to be brought into line.

I am one of those who believes like many who have testified before your committee, that the massive budget deficits that we are currently incurring in this country are a major factor for the imbalance in the exchange rates. I am one who subscribes to restraint in spending throughout the entire budget, not just picking on certain areas. Also, I don't see how we can reduce those deficits without tax increases, tax increases that go beyond those that have already been passed by the House.

In conclusion, Mr. Chairman, let me just say that the trade deficit issue is serious. It is particularly distressing in that the surpluses that we have had in the high technology field are beginning to ebb away and may turn to deficits themselves in the near future.

The combined actions of American business and Government are necessary. American business people have to get away from the idea we can solve our trade problems through protectionism. They have to understand that they have to be competitive in foreign markets if they are going to be competitive here at home. However, in addition, the Federal Government can improve the environment for innovation that will enable us to make those developments that are required for increased competitiveness. Our trade policies have to eliminate barriers and encourage exports. We must have a responsible fiscal policy, in order to bring this exchange rate imbalance into line.

I want to thank you and the committee once again, Mr. Chairman, for letting me share these ideas on the trade deficit with you. I would be happy to answer any questions you might have.

Chairman Gibbons. Mr. Zschau, I think you have made a number of good points, and I am glad to know of your expertise in this area. I think industrial policy that stresses environment is the proper one for the United States. It is useful to compare it with what I see in Japan. The Japanese have a very interventionist policy, in which they have had as many failures by having boards that make decisions as they have had successes. We tend to dwell on this success. They tend to dwell on their failures. That is one of the reasons why we tend to misperceive each other.

I appreciate what you say about education. I visited an engineering school a year ago and the graduates were receiving greater pay than the professors. You could get a job right out of engineering school and you would be paid more than the people that were teaching. That meant you had to be a pretty brave person to hang in there and teach, or else a person that was so antiquated that your skills weren't really desirable out in the field, neither one of which is very desirable for our ability to create a proper environment.

I don't know how we solve that problem, but obviously we can do a lot better than we have done.

Mr. Zschau. I understand, Mr. Chairman, that the problem that you describe there is immense. The capacity of our engineering schools is predicted to produce a rather substantial shortfall of engineers compared to the projected requirements for engineers over the next 5 years.

There are currently 2,000 faculty openings in college and university engineering departments, which gets to the issue that you just raised.

The solution, I think, may lie in the fact that the private sector is extremely interested in solving this problem. If they don't have enough engineers to design the products to meet competitive challenges and the market opportunities, then they are not going to be able to realize their potential.

Already trade organizations such as the American Electronics Association and the Massachusetts High Technology Council have formed nonprofit funds into which their members pay. These moneys then are given in the form of cash contributions to colleges and university engineering departments. I feel that enhancing the tax incentives to make such contributions, such as offering a tax credit for contributions to engineering education, such as we offer to engineering research, may be a way in which the Federal Government can move this process along.

Chairman Gibbons. I appreciate, too, the things you had to say about the constructive efforts that this committee has taken, but there are a few things that you can give us help on.

We haven't had any hearings on FSC to replace DISC. We need to have those hearings very badly. We haven't had any hearings on the R&D tax credit, which apparently is a very important issue, to make the decision as to whether or not we will extend it. So there are some shortcomings that I hope we can measure up to before this session adjourns.

Mr. ZSCHAU. I might just comment, Mr. Chairman, that the other body saw fit to put in the tax bill that is currently in conference not only an extension, but making permanent the R&D tax credit, and there may be an opportunity for the House conferees to recede to the Senate position on that particular measure, and thereby short circuit the hearing process that you just described.

Chairman GIBBONS. The trouble is, I am afraid what will happen is that we will get in conference, and since the Senate bill doesn't raise as much money as the House bill, the Senate conferees will back off on issues such as this, and we won't have anything like that.

One of the problems that is going to be raised from some conferees on our side, I am sure, is that the House has had no hearings on this matter. We don't even know whether the R&D tax credit system that we have in place is working.

Perhaps this will be a slow conference and we can work these things out a little more rationally.

Mr. ZSCHAU. I would be pleased, Mr. Chairman, to participate in those hearings. I have given testimony in the other body on the impact that the R&D tax credit has had since it has been phased in.

Chairman GIBBONS. You mentioned export controls. Unfortunately, or fortunately, I don't know which, those are not under the control of the Ways and Means Committee. But they are certainly a problem that we have talked about extensively, because every time we go abroad and talk to Americans selling American products overseas, they raise the export control issue.

I have seen with my own eyes factories of American machine tools that are being replaced overseas by higher technology goods. One of the reasons is that Americans can't even sell spare parts to the machines they have already sold.

We have gotten ridiculous in this matter of export control, particularly if one of the countries happens to be, say, not a member of NATO or not a member of our Western Alliance.

We are losing markets all over the world, huge markets. You have brought us some good suggestions.

Mr. Schulze.

Mr. SCHULZE. Mr. Chairman, I have no questions other than to thank you, Ed, for very interesting testimony. You have been in the forefront of the high tech era, let's say, and I hope you will continue to keep us informed on your views in this area. They are very much appreciated. Thank you.

Mr. ZSCHAU. Thank you.

Chairman GIBBONS. Mr. Downey.

Mr. DOWNEY. Thank you, Mr. Chairman. I also want to thank our colleague for some very, very enlightening testimony.

Ed, let me ask you about the use of DISC, because you cited it as one of the examples of a tool that your company used. Would you have done exporting anyway even without DISC? Would it have been harder to do, impossible to do?

Mr. ZSCHAU. It is certainly harder to do. The deferral of the taxes on export sales enables one to finance those exports more effectively and it is a motivator.

How much would we have done if DISC weren't in place versus how much we did do? That is impossible to know, but I know that it was part of the decisionmaking process when we began to export and set up subsidiaries throughout Western Europe.

Mr. DOWNEY. If you would elaborate, you didn't like an idea of a formal industrial policy and I see Mr. Lundine is going to testify next. He problably will have a little different perspective than the one I share. You said you wanted to see us more concerned with codifying our interests in research and development and other things. Can you give me a couple of examples of some additional things you would like to see our Government do directly that it is not doing now?

Mr. ZSCHAU. Yes. I have given testimony before the Joint Economic Committee and several other committees in more detail on this particular subject, but, in essence, the idea that I feel is most appropriate for Government's role in promoting not only technology but also industrial competitiveness is to create this environment for innovation. I have tried in prior testimony to identify the prerequisites that I think are necessary based on my personal experience. They are, first, a commitment to basic research, really fundamental research that is done at colleges and universities. It is the sort of research, for example, in DNA that was done not to develop products, but to find out how the genetic processes of the human body work. Out of that came gene splicing technology, and out of that came the fountain for the genetic engineering industry. In good years as well as bad years we need an abiding commitment to basic research. Also we need the modification of the antitrust laws to permit R&D joint ventures. Those are two actions that would enhance that prerequisite.

The second prerequisite is incentives for risk taking. The reduction of the capital gains tax resulted in an outpouring of venture capital. Last year $4 billion of new venture capital was made available in contrast to the average of $50 million a year during the 1970's. In addition to incentives for risk taking for investors, incentives are needed for corporations such as the R&D tax credit or changing and strengthening the patent laws so that the risks that are taken can be fully exploited, rather than having pirate firms, for example, in foreign countries copying the semiconductor designs, without having to incur the risks of the R&D and selling the products here and in foreign markets.

The third prerequisite, availability of trained personnel, really relates to the education issue that we talked about before.

The fourth and perhaps most important prerequisite for innovation is ample market opportunities. People aren't going to take risks and innovate if there is no place to sell the products. That really gets to the trade issue, and it also gets to making sure that our macroeconomic policies are such that we have a strong domestic environment.

My feeling is that if we keep this framework in mind, then as time goes on and events untold, we may identify different bottlenecks. New bottlenecks may arise while others are solved. Our Government actions should be to evaluate the whole set of Government policies in terms of their impact on these particular prerequisites for innovation rather than to have some sort of central planning group that identifies which technologies will actually be developed.

My close friend and colleague in Silicon Valley, Robert Noyce, coinventor of the integrated and the founder of the Intel Corp., which was the first microprocessor company, told a story about industrial policy when he was testifying before the House Banking Subcommittee on Economic Stabilization. He told the story of his wife coming home to him one day and asking him his advice on an investment decision. He said, "That is a crazy idea. Nobody is going to buy personal computers."

She didn't follow his advice. She invested in Apple Computer anyway. The reason he tells the story on himself is, here he was at the cutting edge of the key component in personal computers and he didn't see the opportunity there.

He tells it in order to illustrate the folly of some sort of central planning group to identify opportunities and where to put the money. Rather, we should create the environment such that the private sector will be encouraged to take the risks, try the new things, and identify those opportunities.

Mr. **Downey**. Again, I want to thank you. That is an excellent answer. I agree that to the extent that it is probably impossible to know the new products and the new technology that is right around our door. On Long Island we have Dr. Watson just 10 miles north of my house in Cold Spring Harbor, and we are sensitive, I think, on the island, to what high technology has done. We are among the lowest rates of unemployment.

What concerns me about the notion of industrial policy, if indeed it is limited, in a way that is as you point out understandable because it is hard to anticipate things, it is not hard to anticipate the problems that are occurring in the steel industry. They are obvious.

Or problems in other sectors of our economy that have been longstanding, and it seems to me that we have always had an ad hoc approach to problems like that. When Chrysler got in trouble, we offered them a loan. When Lockheed got in trouble, we offered them a loan, and it is conceivable that some sort of industrial policy that anticipates where the problems are going to be doesn't keep dying industries alive at the expense of more vibrant ones. It is something we need to examine, but your admonition with respect to targeting new ideas is well taken and I want to thank you for very, very fine and illuminating testimony.

Mr. **Zschau**. I want to thank you for the dialog and just comment that we may be arguing more about semantics than about substance. It may turn out that as we explore this further that the sorts of things that I would recommend relating to the steel industries and how they might be able to be rejuvenated through the application of innovative ideas are very similar to the kinds of thoughts you have. I would appreciate the opportunity for that dialog.

Chairman GIBBONS. Mr. Zschau, we appreciate your testimony. It has been excellent.

Are there other questions?

Thank you very much.

Mr. ZSCHAU. Thank you very much, Mr. Chairman.

Chairman GIBBONS. Our next witness is Hon. Stan Lundine, Member of Congress from New York.

Mr. Lundine, we are happy to have you here.

STATEMENT OF HON. STAN LUNDINE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. LUNDINE. Thank you, Mr. Chairman and members of the subcommittee.

Chairman GIBBONS. I would like to say a lot of glowing things about you. The only reason I don't say them is because it would take up so much time here. We appreciate you being here.

We know of your fine background and your hard work and effective work.

Mr. LUNDINE. Thank you very much, Mr. Chairman.

I have a written statement and I would ask that it be included in its entirety as part of the record.

Chairman GIBBONS. It will be included as part of the record.

Mr. LUNDINE. I want to commend you and this subcommittee for holding these series of hearings on our trade deficit. We cannot afford to ignore the trend in our trade accounts.

As you well know, the trade deficit is really the scorecard of how we are competing internationally, and as your charts and other evidence shows, we are in a very serious situation in terms of decline, particularly with respect to our merchandise trade deficit, which will undoubtedly exceed $100 billion this year.

Our relative competitiveness internationally is important because it translates into jobs. In my evaluation we have lost opportunity for two and three-quarter million jobs in America, for the failure of having a positive progressive trade policy.

The causes of this trade deficit are deep-seated and complex, and any attempt to simplify I think would be a waste of the subcommittee's time. However, I was asked by Gillis Long, the Chairman of the House Democratic Caucus, to cochair a task force on international trade in an effort within our own caucus to develop some recommendations on trade policy for our country.

After meeting with private companies, labor, and other trade experts, we developed an analysis and a series of action-oriented recommendations that I believe do speak to some of the solutions.

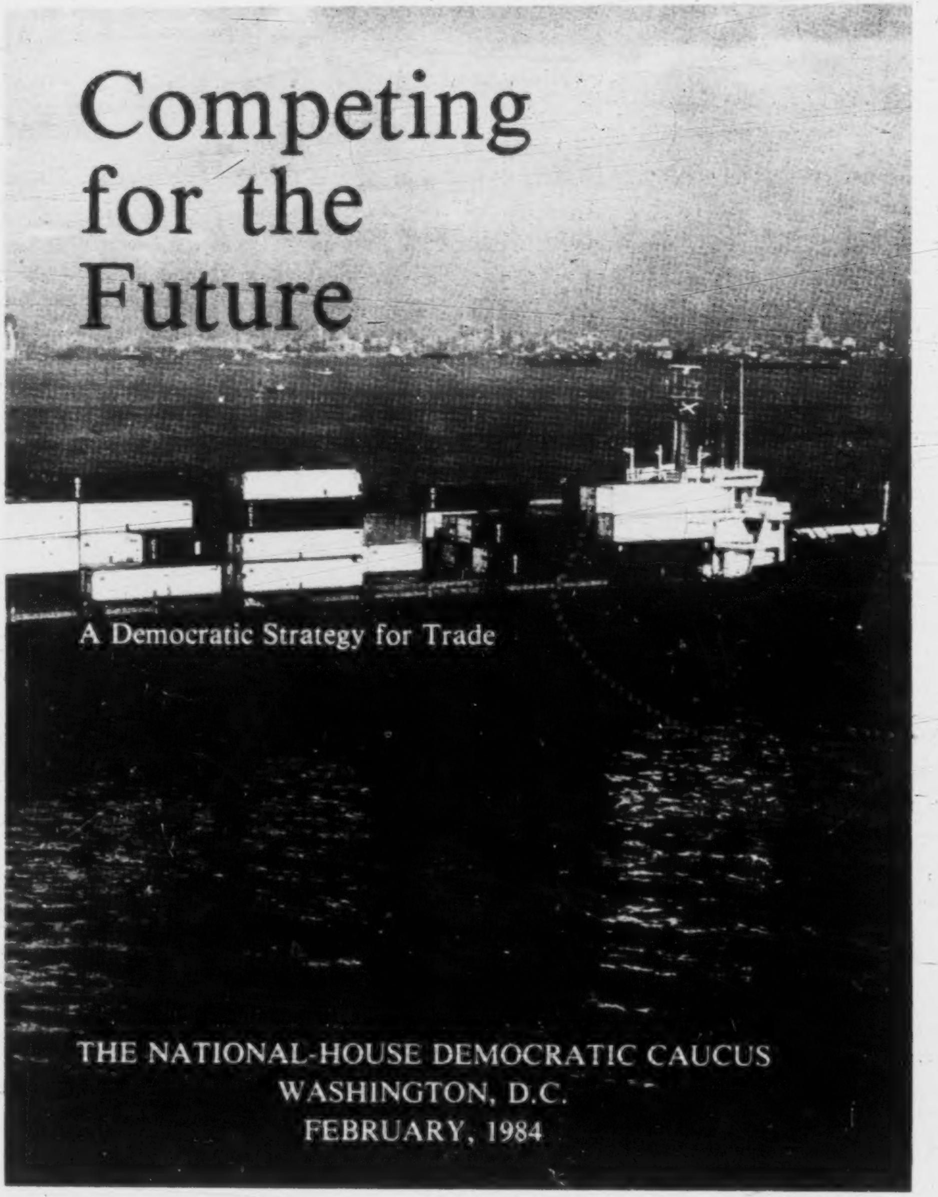
I deeply appreciated your participation and your positive contribution to this report.

Because I believe that it does deal with some of these underlying causes in more detail than I would want to take today, I would also ask permission to submit the entire text of this report into the hearing record.

Chairman GIBBONS. Is there objection?

Without objection, it is so ordered.

[The information follows:]



Competing for the Future

A Democratic Strategy for Trade

THE NATIONAL-HOUSE DEMOCRATIC CAUCUS
WASHINGTON, D.C.
FEBRUARY, 1984

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Congress of the United States
House of Representatives
Washington, D.C. 20515

February, 1984

The Honorable Gillis W. Long
Chairman
House Democratic Caucus

Dear Gillis:

We are pleased to transmit to you this report of the Trade Task Force of the Democratic Caucus.

Just about a year ago, you asked us to assume the Chairmanship of a very diverse group of Members of the House with different philosophies on trade -- and whose districts have had varying experiences with trade. This has been a participatory process which was characterized at times by some difficulties resulting from the diversity of the views of the members of the Task Force. The recommendations expressed in the report, in their entirety, have been agreed upon by the Task Force but do not necessarily reflect the views of any one of its members.

The Task Force agreed unanimously that the United States needs a trade strategy -- and the Reagan Administration has not offered one. The five basic components of that strategy are as follows:

- An active approach for resolving exchange rate imbalances that have resulted in a subsidy on every foreign import and a tax on every American export.
- An industrial strategy for making American industries more competitive in the world economy.
- An export promotion plan that provides American business with the necessary tools to meet the competition in the international marketplace.
- Reform of U.S. trade laws that will result in a more level playing field for American firms in international competition and government agencies that are well organized to meet the challenges ahead.
- Programs to provide American workers and firms with tools they will need as they adjust to the future.

We believe the recommendations in this report comprise a trade strategy that will make the United States a strong international competitor -- to make trade work for us and not against us. We think this report will be of value to the Caucus in the months ahead as you deliberate economic policy.

Sincerely,

Stan — Les

STAN LUNDINE — LES AUCOIN

Summary

In international trade America faces a major challenge, a striking opportunity. The changing character of global competition — marked by aggressive trade strategies of foreign businesses and governments — puts our standard of living at risk. Seventy percent of all goods produced in the United States are in competition — in our market and in sales abroad — with the products of other nations.

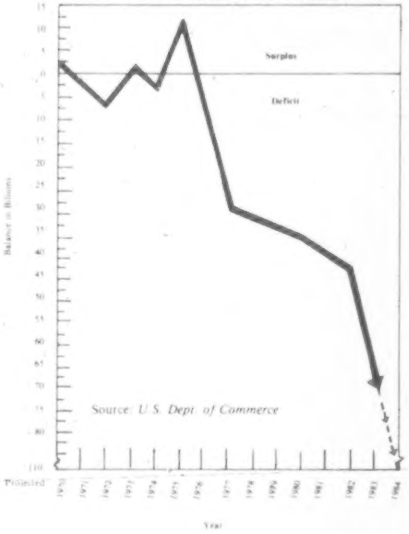
International competition therefore poses a major challenge to an improved standard of living for all our people. At the same time, it also presents a striking — indeed the principal — opportunity for economic growth. In order to face the challenge squarely and to maximize the opportunity, we need to have a coherent trade policy.

Yet, today, the United States has no effective, coordinated trade policy — and that fact is hurting us badly. The imbalance between imports and exports is severe and growing. It is producing mounting deficits in our merchandise trade — deficits in all but three of the last thirteen years, deficits escalating out of control from $36.4 billion in 1980, to $42.7 billion in 1982, to $69.5 billion in 1983.

This report proposes a trade strategy — to make us stronger competitors in the international marketplace, to make trade work for us rather than against us.

The United States has proven that it can compete effectively in the world marketplace. In 1960, the U.S. exported 8.8 percent of its manufactured goods (as a percentage of goods produced). Twenty years later, that

U.S. Balance of Trade



Source: *U.S. Dept. of Commerce*

portion had risen to over 24 percent. Even in the recession year of 1982, exports accounted for five million jobs, one in every eight U.S. manufacturing jobs.

Indeed, export trade accounted for eight out of ten of the manufacturing jobs created during the late 1970s. Even while our excessive dependence on foreign oil kept our trade balance negative after 1975, increased exports accounted for 60 percent of the growth in gross national product during the economic expansion of 1978-1980.

But many of our international competitors, backed with various types of assistance from their governments, are posing a serious challenge to U.S. firms at home and abroad. The damage inflicted on our economy by foreign exporting strategies is clear when we see that:

The U.S. share of the world machine tool market has decreased from around 23 percent in the 1960s to less than 6.5 percent in 1982.

Between 1965 and 1981, the import share of developed countries in the domestic U.S. auto market grew from 6 percent to over 27 percent.

In 1962, the import share of developed countries in the U.S. steel market was barely 5 percent. In 1981, that figure had increased to 25 percent.

In 1958, there was little foreign penetration in consumer electronics. Twenty years later, as an example, there ceased to be any domestic production of home radios.

In 1975, there was zero import penetration in semiconductors. Today, Japanese firms alone have captured 40 percent.

Ten years ago, the apparel and textile industries employed 2.5 million Americans, one out of every seven manufacturing workers. Today, these industries employ 1.9 million. Unemployment in the apparel industry is over 15 percent.

The trend of our overall trade scorecard is disturbing. Since 1970, our trade balance has deteriorated, and our last surplus came in 1975. In 1984, the Administration predicts that the trade deficit could hit $110 billion. These figures show a persistent, widening imbalance between exports and imports; they document a worrisome long-term trend.

Our trade difficulties stem from several causes. First, three years of Reaganomics have weakened America's economic foundation. They gave us the worst recession since the Great Depression, high interest rates, and a dollar conservatively estimated to be more than 20 percent above its proper value against other currencies.

Second, the grossly overvalued dollar, a direct result of the Reagan budget deficits, has exacerbated our trade problem by forcing American products to carry a hidden tax when sold abroad and providing an unseen subsidy for every import.

Third, a bloated dollar and high interest rates are also a principal cause of the international debt crisis — which works to the detriment of American firms in international competition. The debt crisis caused our exports to Latin America to fall by 22 percent between 1981 and 1982. In the 1970s, today's heavily indebted nations had become some of our fastest-growing export markets. Now they simply do not have the money to buy our products.

Fourth, the U.S. lacks an aggressive export policy and effective trade laws that equip American firms with the tools they need to compete effectively in foreign markets.

Fifth, fundamental structural transitions — aging plant and equipment, rapid technological change and the resulting dislocations in communities and the workforce — pose long-term problems to our key manufacturing industries. In addition, American companies are increasingly pitted against foreign firms backed by the aggressive trade strategies of their governments, including export subsidies or import barriers.

Because the Reagan Administration lacks a policy to guide our steps in world commerce, Americans run a double risk both of succumbing to the problems foreign competition poses in our domestic market and of missing the opportunities for growth offered in the global marketplace. Our economic well-being hinges more and more on an effective response — public and private — to the trade challenge. More than just a sense of direction, the nation must have a strategy to deal with the realities of commercial interdependence and clear, effective means for putting our priorities into practice.

In this report, the Trade Task Force of the House Democratic Caucus makes recommendations that meet — head on — the realities of today's world economy. Its main elements and principal recommendations are summarized as follows:

Exchange Rates

An active approach for resolving exchange rate imbalances that have resulted in a subsidy on every foreign import and a tax on every American export.

To bring the dollar's value back into line with other currencies, the U.S. must reduce our towering budget deficits and the high interest rates they sustain.

And to stabilize international currency values, the U.S. should take the lead in convening the major economic powers to explore systems of currency target zones or crawling peg mechanisms that get away from the rigidity of fixed exchange rates without causing dangerous volatility in world money markets.

Industrial Strategy

An industrial strategy for making American industries more competitive in the world economy.

To adjust to structural changes in our economy and fight unfair trading practices of others, we must replace the inconsistent and uncoordinated patchwork of government policies that impede our ability to compete. We need to develop an effective strategy for industrial competitiveness and provide the necessary tools to implement that strategy.

The driving force of this new effort is an independent Economic Cooperation Council to generate the government-management-labor consensus we must have to mold effective competitive strategy. It will also serve to strengthen our capacity to collect, analyze and use data on internationally competitive industries and to develop advisory strategies for specific sectors of the economy. Under this new framework trade actions would be only one tool available to government to assist businesses who can and are willing to take the necessary steps and commitments to become world class competitors.

Export Promotion

An export promotion plan that provides American business with the necessary tools to meet the competition in the international marketplace.

The need to improve America's export performance begins with competitive financing capability. The Export-Import Bank should be adequately funded so that timely and effective financing can be obtained by American businesses. The Bank should move quickly to implement the small business directives initiated by House Democrats and approved by the Congress. When our foreign competitors tie other forms of aid to export credits, the U.S. should counter with competitive aid packages. The Bank should take the initiative in responding to finance bids by American companies for sales in the U.S. against subsidized competitors from abroad.

With regard to export controls, the Commerce Department should strike a more sensible balance between economic priorities and national security concerns. It should drop licensing requirements both for exports to friendly nations which cooperate in controlling their re-export and for items widely available from other counties. And it should act more swiftly to process export license applications.

Trade in services and agriculture represent two areas where we can increase our exports.

To expand the U.S. share of the burgeoning world market for such services as banking, insurance, transportation, engineering and telecommunications, the U.S. should both press for negotiations to liberalize trade in services and authorize the President to block the import of services from any nation which discriminates against U.S. service exports. A concerted effort to collect data on domestic and foreign service activities and issues should also be undertaken.

Forswearing embargoes and working to bring the dollar's value — and hence the cost of U.S. goods — back into balance, we should also strengthen such loan and guarantee programs for farm exports as those of the Commodity Credit Corporation and should extend credit terms under the "Food for Peace" program to ten years instead of three. While pressing our trading partners to do away with practices that reduce free farm trade, we should also drop needless export controls on our own goods.

Trade Laws and Organization

Reform of U.S. trade laws that will result in a more level playing field for American firms in international competition and government agencies well organized to meet the challenges ahead.

Existing trade law provisions should be reformed and aggressively used to aid U.S. firms injured by unfair foreign trading practices. America must drop its reluctance to assert the rights of our own trading firms and stress the goal of fair trade. We should also call for immediate international negotiations to obtain open markets and deal with non-tariff restrictions on trade. At home, in the interim, we should gear our trade laws to be invoked more readily against both real and threatened injury and to operate effectively against dumping practices by non-market traders.

We believe that once a comprehensive trade policy is established, a realistic and rational trade reorganization plan can contribute significantly to the goal of making the United States competitive.

Trade Adjustment

Programs to provide American workers and firms with tools they will need as they adjust to the future.

The United States needs a trade adjustment program to help dislocated workers find new employment in permanent, high-quality jobs and to help trade-impacted industries restructure and anticipate new competitive challenges. A standardized computer job bank and a skills development program, financed by earnings from customs duties, would provide effective aid to workers in finding and equipping themselves for new jobs. For firms in tough competitive fights, new incentives are needed to expand production in the U.S. We must provide better support for new product or process development and greater emphasis on producing for export.

Introduction

The proposals in this report are designed to expand the economy, create and preserve jobs, strengthen American businesses and increase the American standard of living. Our strategy relies on understanding the importance of both exports and imports to our economy.

Exports have become a powerful driving force in the U.S. economy. If our economy is to expand we must export. An effective exporting strategy requires a combination of tools to meet and counter the targeting practices increasingly used by our competitors. In growth industries, such as robotics, American firms are often competing against heavily subsidized foreign industries which are backed by coordinated govenment and private action.

One example is the use of aggressive foreign export credit programs, often tied to various forms of foreign aid. They place American firms at a disadvantage in export competition and result all too often in lost sales. Additionally, many forms of non-tariff barriers continue to hinder U.S. firms' access to foreign markets, particularly in the area of services, agriculture and high-technology manufactured goods.

At home, the flood of imports has both positive and negative impacts on our economy. To succeed as exporters, we must see trade as a two-way street. Imports spur healthy competition and broaden choices for consumers. However, we must be sensitive to the fact that imports may also threaten to undermine critical industries and the jobs of millions of American workers.

The Task Force recognizes that it is not desirable to attempt to stop the flow of imports. We need only to remember the chaotic conditions of the 1930s, when all nations tried to export while closing their markets to imports, to know that raising barriers is not the solution.

We seek an unencumbered world economy free from artificial controls, and we support efforts to lessen and eliminate barriers to trade. Democrats have a consistent record of effort to bring down those barriers, efforts which aided the six-fold increase in the volume of world trade since World War II.

Nevertheless, it is clear that the threat to American trade-related industries and American workers is currently too great to ignore.

We must help many of our economy's older manufacturing sectors adjust so they can compete effectively. We cannot abandon them. They must form the foundation for economic growth. Growth in the sales of services, for example, will increasingly depend on the competitiveness of our manufacturing base. If we are not manufacturing products in a given sector, it is unlikely that we will provide consultant services involving those goods. In addition, many such industries as automobiles, machine tools and semiconductors support important supplier industries which are necessary for economic growth.

Our older industries confront serious problems, including outdated facilities, internationalization of capital and technology, low-wage foreign labor, an overvalued dollar, and the lack of a coherent, clearly defined trade policy. These problems cannot be solved overnight, but they must be addressed without further delay.

We are committed to making our key traditional industries competitive. Our trade policy must be coordinated with other economic policies to restore these ailing segments of our economy to health. And we must also aid the millions of workers whose jobs — even with industrial modernization — will disappear in a rapidly changing economy.

We must move beyond ideological debates about the merits of free trade versus protectionism. Our balance of trade deficit is too large. International competition is increasing too dramatically. We must develop and implement a policy to promote American competitiveness and economic growth.

Protectionism is not a long-term solution to our problems. We propose instead a positive restructuring program, built upon commitments from labor and business. Trade relief, if necessary, should be temporary. Because the American economy is so diverse and complex, remedies should develop through consensus and should take into account the unique competitive problems of different sectors of the economy. The Reagan Administration has no coherent approach to trade. We propose a comprehensive strategy, one which takes these interrelationships into account, so that the prescriptions designed for some do not inadvertently affect the trading positions of others.

There are no quick-fix solutions. Democrats understand that trade will play an increasingly important role in our economy. We are ready to face the challenges that will accompany it.

Government, labor, and business must work cooperatively during this time of challenge both to foster economic revitalization and to lay a sound basis for future progress. New approaches — not traditional, reflexive responses — are needed to meet the new realities of international trade. Our strategy must increase the American people's standard of living, provide secure jobs, and help businesses, large and small, compete on an equal footing with foreign competition.

The Administration has failed to devise a trade policy that can help prepare our economy for continued, intense, international competition, now or in the future. This report is an alternative to the slick slogans and the rigid ideology of the Reagan Republicans.

Taken together, the Task Force recommendations provide the keys to overcoming the imbalance between imports and exports.

Democratic alternatives can set us on the right path toward competitiveness, job opportunity, a higher standard of living, and a fair and steady transition into a future we can make the most prosperous in our history.

Exchange Rate Imbalance

Correcting the exchange rate imbalance is a necessary pre-condition to improving America's trading position. The value of the dollar is at least 20 percent higher than it should be in comparison to other major foreign currencies. This imbalance is the most serious since fixed exchange rates were abandoned a decade ago. It means that U.S. exports, in effect, carry at least a 20 percent tax while imports into the U.S. carry at least a 20 percent subsidy.

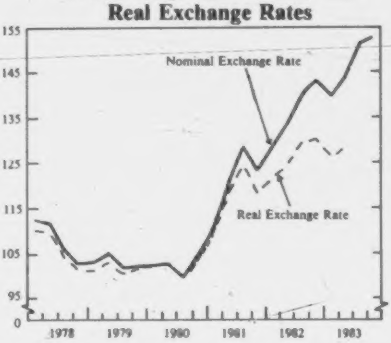
This hidden tax on U.S. goods and hidden subsidy on foreign-made goods makes imports very attractive to U.S. consumers and makes U.S. goods less attractive to foreign buyers. It has also made it more profitable for U.S. firms to build plants abroad where the dollar buys more than it does at home. The overvalued dollar thus costs U.S. jobs, U.S. exports, and investment in U.S. firms.

Although the Reagan Administration created the exchange rate problem, it has steadfastly refused to take any real corrective action. The enormous Reagan budget deficits, tight monetary policy and the resulting high interest rates are the major causes of the overvalued dollar.

Extremely high U.S. interest rates act like a magnet, drawing in capital from around the world as investors demand dollars to get the best return on their money. Since 1980, over $70 billion have poured into the U.S. As investors sell foreign currencies and buy U.S. dollars in such proportions, the value of the dollar skyrockets.

Although the overvalued dollar has helped lower inflation and to finance the federal deficit through increased sales of U.S. Treasury bills to foreigners, its negative effects far outweigh the benefits.

Trade-Weighted Nominal and Real Exchange Rates

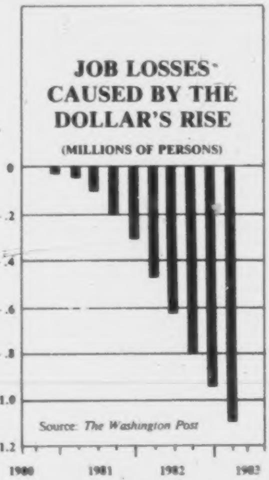


SOURCES: Federal Reserve Board; International Monetary Fund.

NOTE: Federal Reserve Board Trade-Weighted Exchange Rate and real exchange rate are rebased so that the third quarter of 1980 = 100. Real Exchange rate is a trade-weighted nominal exchange rate adjusted by trade-weighted relative value-added deflators.

Effect on Jobs

Since 1980, the exchange rate imbalance has contributed substantially to the loss of more than a million U.S. jobs and over a one percent loss in U.S. gross national product. Foreign imports have increased by over $10 billion and American exports have decreased by more than $35 billion. That deterioration has accounted for over half of the decline in real GNP during that period and was an important cause of the severe recession.


JOB LOSSES CAUSED BY THE DOLLAR'S RISE

(MILLIONS OF PERSONS)

Source: *The Washington Post*

Effect on Investment

Our overvalued currency has caused many companies to divert their investments to overseas uses, sapping sorely needed domestic capital sources. An estimated $7 billion in domestic investment was lost in the first quarter of 1983 alone because of the overvalued dollar. These investments might otherwise have been put into U.S. plants to increase their competitiveness.

Effect on U.S. Exports and Imports

U.S. companies have lost valuable export markets as a result of the artificially strong dollar. The overvalued dollar means that in export markets, given the choice between artificially high-priced U.S. goods or lower-priced competition, non-U.S. goods are likely to prevail. Our exporters are losing badly because of this imbalance and they are finding no ally in the Reagan Administration.

The Administration's unwillingness to take bona fide steps to bring the dollar into line with other currencies has effectively eliminated the U.S. farmers as strong competitors in new international agricultural markets. Similarly, agriculture equipment producers have been devastated in their efforts to sell abroad. The domestic price of wheat rose only one cent, from $3.33 to $3.34 per bushel, between August 1980 and August 1983. However, because of the exchange rate imbalance, in terms of Australian dollars, from August 1980 to August 1983, that price rose 32 percent, from $2.89 to $3.82. In terms of the Deutschmark, it rose from $5.97 to $9.11, a 52 percent increase.

And Americans are not the only ones to suffer. European countries have had to prop up their interest rates in order to prevent the further devaluation of their currency in relation to the dollar. Higher interest rates in Europe, like those at home, have dampened economic activity, prolonging the world recession. The result abroad, as at home, has been economic stagnation and unprecedented levels of unemployment. The European recession, in turn, has drastically reduced the European demand for U.S. goods, hampering the ability of U.S. firms to exploit new export markets.

European leaders have been calling upon the Administration to ease up on interest rates and to intervene in currency markets in order to bring the dollar back in line, arguing that the health of European economies and of our own depend on such action. But the Administration has done little to answer these appeals.

The bloated dollar also worsens the debt problems of developing countries. They must service their debt in costly dollars and at high interest rates, increasing their balance of payments problems, reducing their ability to buy U.S. goods and pressuring them to increase their exports to our country.

President Reagan has failed to take effective action to correct the imbalance in exchange rates. Interest rates have remained high throughout his term in office and he has been slow and timid in joining with the Congress to devise a constructive plan to curb deficits, a prerequisite to bringing down interest rates and correcting the exchange rate imbalance. Forceful action to reduce the deficit, as proposed by the National-House Democratic Caucus in *Renewing America's Promise: A Democratic Blueprint for Our Nation's Future*, is essential to correcting the exchange rate imbalance.

In belated acknowledgment that we have a dollar problem, the President, in his 1985 economic report, predicted that the dollar's value will remain high for another 10 years. However, he proposed no effective strategy to soften the bloated dollar's impact on U.S. competetiveness today. The Administration has attempted to rationalize the artificially inflated dollar as desirable to attract foreign capital to finance its burgeoning deficit, giving little thought to export losses or to the 1.2 million lost jobs.

The Administration's rigidity on exchange market intervention has created serious tensions with some of our key allies. At international meetings, including the Williamsburg Summit, they have been calling for U.S. exchange market intervention at least to stabilize exchange rates.

When the Administration finally did intervene, in July

1983 — when the dollar was at the highest level against the German mark in nine years — it made only a token effort.

Several options for currency intervention should be considered. Both the target zone and the crawling peg systems would be compromises between the rigidity of fixed exchange rates and the volatility of flexible ones. In the target zone system, acceptable high and low exchange rate levels would be found through on-going multilateral negotiations with our major trading partners. Although exchange rates would usually be kept within the desirable ranges, the trading nations would not be obliged to maintain the value of their currency within the band against their national interest. In a crawling peg system, nations would be more committed to staying within the desirable band of currency levels.

The essential value of both systems is that small changes could be made more frequently in currency exchange rates, bringing more stability to the international economy and preventing any one nation's currency from becoming too far out of line with those of other nations. These options are just two of many that should be discussed at an international conference to develop a framework for exchange rate stability.

In any case, currency intervention should be used sparingly and only as a short-term measure. In the long run, the solution to our dollar problems is to reduce budget deficits and bring down interest rates.

Over the long-term many steps must be taken to stabilize exchange rates:

- *The budget deficit has grown from a low of $29 billion under the previous Administration to $194 billion in fiscal 1983. These unprecedented Reagan deficits have, in turn, pushed up real interest rates. If the Reagan economic program continues, the federal deficit will reach $249 billion by 1988, about five percent of our Gross National Product. We are committed to take the deficit reduction steps detailed in the Democratic Blueprint.*
- *The Federal Reserve Board should change current policies and respond to lower deficits by keeping real interest rates down. Controlling the money supply is not the only monetary policy instrument available to the Fed. The Fed should take real interest rates and the level of the dollar in foreign exchange markets into consideration in formulating monetary policy.*
- *The Administration and the Federal Reserve Board must consult with the Congress on a regular basis on the state of the dollar. the steps needed to bring its value in line with other currencies, and the status of negotiations to reform the international exchange rate system.*
- *Once we have brought exchange rates into line and have stabilized the dollar, attention should be given to the effect of U.S. banking policies on dollar investments abroad.*
- *Whereas U.S. financial institutions are required to hold a certain amount of their funds in reserve, not to be lent out, financial institutions abroad have no required reserve ratio, allowing them to lend to the limit of their assets and offer lower interest rates as a result. It has been estimated that as a result of the required reserve ratio in U.S. banking, over $100 billion was transferred into foreign banks last year alone. This creates a very serious drain on the capital that is available for investment in this country.*

Industrial Strategy

Sound fiscal and monetary policies can — and must — provide the base for stable and sustained economic growth. But strategic measures tailored to address the problems for key sectors and regions are also needed to rebuild America and make it fully competitive again.

To meet fundamental long-term problems of competitiveness, we must have a new strategy that blends growth-oriented economic policies, public and private investment, and specific structural measures to build new productivity growth on a solid foundation.

Holding to the belief that an unfettered free market operates in the international economy, the Reagan Administration has refused to coordinate trade and economic policies to improve our industrial competitiveness. That unrealistic approach has left our domestic producers at a great disadvantage compared to foreign competitors.

Our companies are no longer in competition only with foreign companies in a free global market. Instead, they compete with foreign companies working hand in glove with their own governments, which subsidize promising growth industries and the restructuring of ailing ones, erect non-tariff trade barriers, encourage dumping, and impose restrictive regulations. Macroeconomic policies alone, no matter how sound, cannot counter such aggressive competitive techniques.

At the same time, the structure of our economy is changing rapidly. From 1964 to 1983, the rate at which economists define full employment at the height of the business cycle has moved from 4 percent to 6 percent and higher.

Millions of American workers are structurally unemployed. This is one of the most significant changes that has occurred in our economy, and traditional macroeconomic policies are simply not equipped to bring us back to 4 percent full employment when faced with such massive structural changes.

The U.S. must act to put us on a level playing field with our foreign competitors. We can either ask our competitors to change their strategies for trading and competing, or we can change ours. Although it is very important that we initiate negotiations with our competitors, we cannot expect other nations to scrap their trade and industrial policies. It is up to the U.S., the federal government as well as private business, to take positive, aggressive steps to improve our own ability to compete in international markets.

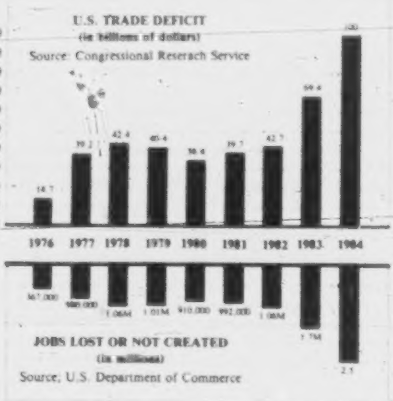
Faced with the structural changes in our economy, the predatory practices of our competitors, and the urgent need to maintain our international competitiveness, the U.S. cannot do without an industrial strategy; one which will replace the ad hoc, inconsistent patchwork of policies which now hinders the ability of our trading firms to compete effectively. Even as the long-awaited recovery proceeds, our trade and structural problems will remain. We propose a national industrial strategy as an essential element in rebuilding our competitive strength.

Such a strategy will not direct the market. Rather, it will allow our industries to compete with fewer impediments.

The cornerstones of that strategy, in addition to getting macroeconomic policy in order, are the creation of an Economic Cooperation Council to anticipate and develop strategies for taking advantage of opportunities and dealing with problems, and a public and private investment program — in plant and equipment, research and development, education and training, and the public infrastructure.

Our industrial strategy must include trade policies. A critical element in our strategy must be to assist important manufacturing industries — many hard hit by imports — to modernize and become more competitive.

Periodic, temporary restraints on imports may be needed to allow such important industries to retool and reinvest, to become more competitive. Clearly without an affirmative industrial strategy supported by tough, consensus-based trade policy, there will be rising pressure for strong protectionist measures.



The United States needs to retain world leadership in basic industries such as automobiles, which are important to a whole range of strategic industries, including steel, aluminum, glass, malleable iron, textiles and synthetic rubber. Autos are also crucial to high technology jobs in numerically controlled machine tools, robotics, computers, and other industries. We are committed to taking the necessary steps to insure a healthy and competitive auto industry in the United States.

Domestic content is one approach that has been suggested to address this problem. Some Democrats believe that this approach would be an effective measure which would preserve existing jobs, assure the United States a reasonable share of future world auto investment and jobs, and insure that we retain a viable automobile industry. Others, however, as an alternative, believe in a strategy that deals with the entire international competitive issue and assures that American companies have every incentive to maximize both capital investment and jobs here.

When it is established, the Economic Cooperation Council will provide a forum where federal policies affecting the future of important industries can be developed as part of an integrated strategy.

For example, representatives of the American auto industry, its suppliers, union, and consumer representatives might be convened to work out a strategy to strengthen the domestic industry. Such a strategy should include trade actions necessary to sustain the industry's competitive position.

There are four basic components of a positive national industrial strategy:

- *First, and most important, a sound industrial strategy must be based on consensus. We propose a broadly representative, independent Economic Cooperation Council where top representatives of business, labor, government and the public can be heard.*

By involving all the major stakeholders in our society, the ECC will be in a position to extract commitments in return for governmental assistance. Rather than current give-away programs of federal tax credits, guaranteed loans, and forms of trade protection which require nothing in return, the American people should be assured that assistance to industry will result in greater productivity and investment. In the same way, if an industry takes high risks and invests in productive capacity, it should have access to a stable source of long-term capital.

We must begin give-and-take negotiations if we are ever to move away from our shortsighted fixation on quarterly profits, the next labor contract, and the next political election. We must move toward a longer term view of returns in the form of higher productivity, capital investment, and innovation.

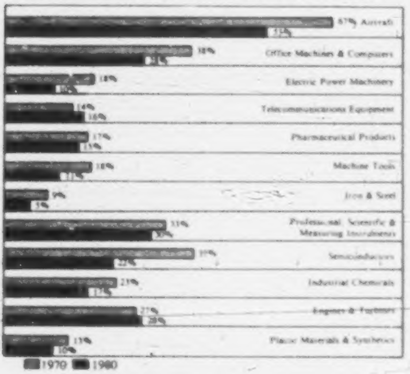
- *Second, we need to improve our national capacity for data collection and analysis. We need an accurate gauge of the status of our internationally competitive industries, of which regions need help in adjusting to the impact of foreign competition, and where our biggest problems, as well as our greatest strengths, lie.*

Today we lack that knowledge. On every issue, different sources present different facts to support their own cases. Data now collected by the government is uneven in quality and is often not relevant to identifying and solving problems. Without a consensus on the facts, we cannot hope to develop sound programs to revitalize our industries and to get our labor force back to work.

The Economic Cooperation Council would develop credible data and then provide private business and the public sector with the best information available with which to make decisions.

- *Third, we should develop a national industrial strategy and specific strategies for individual sectors of the economy. For this purpose, we recommend the creation of subcouncils of the ECC. These subcouncils, like the Economic Cooperation Council, would include leaders of business, government, and labor, and the public.*

Trends in U.S. World Market Shares



These sectoral strategies must be consistent with the ECC's national strategy. They should point out linkages between mature and emerging industries, identifying where mature industries could use high-tech innovations to increase competitiveness and where high-tech industries should turn their innovations more quickly into commercial application.

Such sectoral strategies could also help our industries counteract the targeting techniques of our international competitors. The U.S. semiconductor industry, for example, is the object of very deliberate targeting by the Japanese government. In the early 1970s MITI decided to develop a semiconductor industry in Japan that would compete with U.S. chips in world markets. The Japanese erected non-tariff barriers and provided the seed money for commerical development in the form of loans with repayment conditional on the project's profitabilty. By reducing the investment risks for Japanese companies and through aggressive export promotion programs, Japan nearly cornered the market on the most advanced chips by 1980.

At the same time, the U.S. semiconductor industry — the pioneer in the technology — faced severe capital constraints as a result of the 1975 recession. The combination of Japanese targeting and limited U.S. capital enabled the Japanese to expand their export of integrated circuits to the U.S. from about 50 million in 1977 to about 300 million in 1980 and to finance additional development of this technology.

The United States has pursued successfully aggressive sectoral strategies in the past.

The formation of land-grant colleges, the passage of the Homestead Act, federally conducted crop research and infrastructure improvements to guarantee production and transportation of farm goods have contributed immensely to our country's worldwide leadership in agriculture.

Similarly, industrial policies have aided the aluminum, rubber and semiconductor industries in this country. Even NASA started as an industrial strategy effort under President John F. Kennedy. We are now beginning to realize the almost limitless commercial possibilities of efforts in space.

The recommendations of the ECC would be advisory only. Industries would not be required to approach the ECC or to follow its recommendations. Legislative recommendations made by the Council would be debated by Congress and any recommendations would travel the same legislative route as other proposals.

- *Fourth, there are gaps in the availability of capital for productive investment needed to revitalize our basic industries and to finance our emerging industries.*

Democrats in *Renewing America's Promise* have proposed a speedy but careful study of the efficiency of current federal credit programs in meeting overall and sectoral capital and credit needs.

In addition, several positive and not necessarily mutually exclusive alternatives for action have been advanced by Democrats. One would augment existing private-sector financing by establishing an industrial development bank to provide capital for the restructuring of mature industries as well as "patient" capital for emerging companies. Another would create a secondary market for industrial mortgages.

* * * *

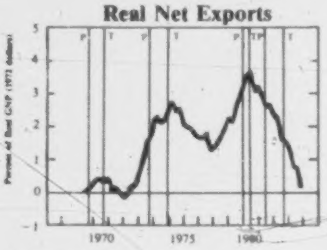
An industrial strategy can help create a new comparative advantage for the U.S. As a direct result of the increased mobility of capital, labor and technology, the United States has lost advantages it once had. By focusing on our strengths and spurring productive and competitive investment, we can rebuild our competitive edge and help to make the U.S. a more stable, stronger trader.

Export Promotion

Exports represent nearly 12 percent of the American GNP—twice their level 10 years ago. Every billion dollars of exports creates at least 25,000 new U.S. jobs. One in every eight manufacturing jobs depends on exports, and we export 60 percent of our agricultural goods.

Increasingly our growth depends on our ability to sell more abroad than we buy. But from the beginning of 1981 to the end of 1982, real net exports in 1972 dollars fell $21 billion, accounting directly for 69 percent of the decline in real GNP in these years.

Even as sales abroad increased in importance to our economy, we have been losing our share of total free-world exports. In 1970, for instance, the U.S. held a 15.4 percent share of that market, but by 1981, that figure had dropped to 13 percent. In those same years, Japan increased its portion from 6.9 percent to 8.4 percent.



SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis. Note: P and T lines indicate business cycle peak and trough dates.

Since lesser-developed countries represent increasingly attractive markets for U.S. goods, a stable international financial system is in the interest of the United States.

A strategy to renew America's competitiveness again must do what the Reagan Administration fails even to contemplate. It must:

Recognize both the growing importance of exports and the heightened competition;

Provide the necessary tools for U.S. exporters to compete effectively in the world marketplace;

Forswear use of tactics such as trade embargoes — like the Reagan Republicans' failed attempt to block sales of equipment for the Soviet natural gas pipeline — as substitutes for strong foreign policy. Such tactics fail to achieve their foreign policy goals, and, by making America less than reliable as a supplier, shrink our export opportunities.

It is also essential for U.S. businesses to be more aggressive when it comes to international trade. To insure competitive U.S. exports in the future, our firms must intensify their search for foreign markets. U.S. firms must become more internationally minded.

Export Financing

We would prefer that tax-supported subsidies not be used to promote American exports. First and foremost, we support efforts to end the use of subsidies, mixed credits and other devices used to underwrite export sales. Negotiations should be entered into and tirelessly pursued to put an end to these practices.

Yet, until they can be eliminated everywhere, we back credit programs that will give U.S. exporters government support on a par with what our competitors provide.

The Reagan Administration has been openly hostile to the Export-Import Bank (Eximbank), one of the major government organizations which can strengthen the competitive position of American exporters. In stark contrast, the United Kingdom and Japan, in 1980, provided official incentives for 35 percent of their exports. France underwrote 29 percent; Germany 12 percent. Eximbank support went to only six percent of U.S. exports, and Administration budget requests tried to push that figure even lower.

This Administration's disdain for Eximbank financing makes no economic sense. Since its creation in 1934, the Bank has generated dividends of nearly $1.2 billion and retained earnings of $2 billion from an initial capital stock outlay of $1 billion.

Both the variety and the level of support provided by foreign governments for their exports put American exporters at a decided disadvantage. Unfortunately, foreign governments don't stop there. Some nations cover a larger percentage of the value of exports than the U.S. does; some extend mixed credits to their buyers; some provide insurance against cost escalation and currency fluctuation, and some provide direct operating subsidies for their Eximbank equivalent.

A stronger Eximbank is essential if United States exporters are to meet the challenge of foreign competition.

- *As a primary objective the Bank must provide full competitive financing in all of its programs for American exporters faced with officially subsidized credit competition in foreign markets. Without ignoring its own costs, the Bank, first and foremost, must be competitive.*

House Democrats took an important step to restore adequate levels of Eximbank lending authority. They included $4.6 billion for direct loans in the House-passed budget resolution for this fiscal year, raising the Administration's recommendation of $3.83 billion. Moreover, the resolution included $10 billion for the increasingly important loan guarantee program.

At the same time, Democrats hold that the Eximbank should restrict its activities to those in its charter which tie loans to specific U.S. exports. The Reagan Administration has forced the Eximbank to address international balance of payments problems that are more appropriately handled by other world lending institutions. Eximbank funds should remain strongly tied to loans and loan guarantees dealing with specific transactions.

We remain committed to providing adequate levels of support for the Eximbank because increased exports mean jobs.

- *The Eximbank should respond more vigorously to small businesses, source of the greatest potential for export expansion, for new job creation and new industries. The Bank should move quickly to implement recent congressional directives initiated by Democrats in the House. It should reserve a portion — higher than the three percent of its direct loans and guarantees allocated to small business in fiscal 1982 — for small businesses, make its programs more accessible to them, promote a medium-term credit program for them of fully competitive financing and increase small business representation on its Board of Directors.*

The Department of Commerce estimates that there are at least 20,000 businesses in this country that could export but do not. They are missing opportunities in the rest of the world — where 93 percent of the globe's population lives — and neglecting markets where much of our economic future will be determined.

- *While urging negotiations to end the practice of other nations in tying aid, export credits and commercial capital into packages of mixed financing for exports, we believe the U.S. should not come to the bargaining table empty-handed. We would therefore authorize the defensive use by the Eximbank of mixed credits to neutralize foreign subsidies, but not to back up bids that would otherwise not be competitive.*

The Eximbank has been handicapped by its inability to match the tied aid or mixed credits other countries offer. For instance, a West German firm backed by a mixed credit won a $47 million sale of hospital equipment to Venezuela. A U.S. firm lost a $24 million Indonesian order for 24 locomotives to a United Kingdom rival because of mixed credit and financing.

- *Finally, we must challenge such foreign-subsidized sales in the U.S. as the recent Canadian subway-car deal. If the Treasury Department determines that foreign export credit is a significant factor in a sale within the United States, we support domestic financing through the Eximbank to even the competitive situation.*

Export Controls

The preeminent function of government is to protect and promote our national security. At the same time, we must also protect and promote America's economic interest. In its efforts to restrict exports, the Reagan Administration has upset the balance between our security and economic interests. Even for items of little or no military relevance, it forces American exporters to wade through a costly tangle of red tape and bureaucratic obstruction.

This Administration has failed to recognize that our economic strength in the world is no less an element and guarantee of our national security than our military strength. Export controls which unnecessarily damage the competitiveness of U.S. industry are, in themselves, damaging to the national security. Economic growth, jobs and an increasing standard of living for American workers are key elements of our power in the world and our safety at home.

The Administration now restricts exports of thousands of products which our adversaries, even if they want them, can readily obtain from other sources. The result is a leaky system of export restrictions that often hurts our own economy more than our rivals'.

We propose to remove these unnecessary, damaging barriers to American exporters and to develop an export control policy that will focus our attention squarely on those items which are truly vital to national security.

Over one-third of the 80,000 export license applications the Commerce Department receives each year are for products destined for countries which cooperate with us in keeping sensitive items from going to the Soviet bloc. But even these applications require time-consuming processing. The system of licensing and controls creates a costly burden to government and a bottleneck in export trade with delays of up to one year becoming commonplace. The list of controlled goods and technologies is too long and should be shortened.

Multilateral export restrictions, on the other hand, are the most effective means we have to deny the Soviets sensitive items from the West. Unilateral American export controls have not succeeded in keeping critical products and technologies away from the Soviets or other eastern-bloc nations. Not only have these controls been largely ineffective, they have been damaging to American exporters who face restrictions on many items that are freely sold by foreign competitors.

By applying unilateral controls even to existing contracts, the U.S. has damaged our own exporters without keeping critical goods away from the USSR. Moreover, we have created the impression among many prospective foreign customers that U.S. producers are unreliable suppliers. This stigma of unreliability spreads beyond the goods and technologies directly controlled or the specific countries subject to economic sanctions. The negative image extends to virtually all U.S. exports, from soybeans to semiconductors, and all U.S. trading partners, friend and foe alike.

Importers around the globe back away from depending on U.S. suppliers specifically because of the frequent and unpredictable application of U.S. export restrictions for foreign policy purposes. The Administration's attempt at extraterritorial application of American export controls worsened the pattern. Such extensions of U.S. law to companies located in foreign countries and directly subject to foreign laws not only damage the reputation of U.S. producers; they damage the reputation of the U.S. government.

Enforcement of export restrictions has been increasingly burdensome for law-abiding American exporters. Under "Operation Exodus," the Customs Service has held up thousands of legal shipments at ports around the country, unfairly harassing many exporters with random searches. The Customs Service clearly has a supporting role to play in enforcing export controls, but Customs agents do not have enough expertise in licensing requirements and commerical technologies to take the lead. The Administration's effort has been, for the most part, yet another needless trade barrier to U.S. exports.

The Export Administration Act of 1979 grants the President sweeping authority to impose export controls. Yet requirements for prior consultation with Congress and industry are weak and routinely ignored. Consultation with allies is not required at all, and, consequently, effective multilateral controls are rare.

The extensive list of controlled products and technologies has resisted reduction, even in light of the clear intent of Congress that the list focus only on items of military significance. Enforcement efforts have been divided and, as a result, ineffective.

In spite of these glaring problems the Reagan Administration has proposed broadening Presidential discretion, enlarging the size of the control lists, maintaining and expanding the use of unilateral export restrictions, and perpetuating the division of enforcement responsibilities. The adoption of the Reagan plan would be a slap in the face to American exporters and American allies. This double indignity will not only injure U.S. business; it will damage our national security as well by further weakening relations with our allies. This proposal demonstrates the hollowness of the Administration's commitment to expanding U.S. exports.

To achieve a balanced, workable system of export controls, we propose:

- *Deadlines for the processing of export license applications should be strictly observed and in certain cases shortened to ensure swift action by the responsible agencies.*
- *The Commerce Department should maintain its lead role in administering and enforcing export controls and should be given the necessary enforcement tools.*
- *License requirements for exports of cooperatively controlled items to friendly nations should be removed.*
- *Products which are readily available worldwide should be decontrolled unless the foreign availability of these products can be effectively and expeditiously eliminated.*
- *Items which are routinely approved for export should be decontrolled.*
- *Existing contracts should be given effective protection from foreign policy export controls, except when expressly authorized by Congress.*
- *Foreign policy export controls should not be applied extraterritorially without Congressional approval.*

Export Trading Companies

Because of the initiative and persistance of Democrats in Congress, the Export Trading Company Act, first introduced by former Senator Adlai Stevenson, was adopted in 1982. In the House, Democrats were the prime sponsors and movers of this landmark legislation which allows companies to pool resources to become more efficient exporters.

The Export Trading Company Act stands as a model of what can be done to promote American exports and American jobs, providing a powerful instrument for bringing small and medium-sized firms into the export market. Chase Econometrics has estimated that export trading companies could increase U.S. exports by five to twenty percent over the next five years. Even if the increase is only five percent, as many as 350,000 American jobs will be created, and exports will be expanded over $11 billion.

But for Democrats, enactment of the Export Trading Company Act was only a beginning. To enhance the usefulness of the law's new concept, we support:

- *Reform of the stringent limitations on import activities which may deny export trading companies the flexibility to conduct extensive worldwide trading operations. Such rigidity may limit business and bank participation in the program.*
- *Adequate resources and support for export trading companies from the Eximbank and the Small Business Administration.*
- *A provision for extending export tax benefits to export trading companies. This should be corrected within the context of reform of the Domestic International Sales Corporation.*

Trade in Services

The United States is the world's largest producer, consumer and exporter of services.

The services sector of the American economy — banking, insurance, transportation, engineering, data processing, telecommunications, and numerous other business activities — accounts for 66 percent of our GNP (54 percent excluding government), for seven out of every 10 non-agricultural jobs.

But as total world trade in services grew by 149 percent between 1975 and 1980, the U.S. market share declined from 20 percent in 1972 to 15 percent in 1980.

U.S. service exports, moreover, generate demand for U.S. merchandise exports. The International Trade Commission found that U.S. service firms' activities abroad resulted in U.S. exports of about $3.4 billion in goods in 1982. If trade barriers had not stood in the way, service firms' own revenues would have been about $1 billion higher in 1981, and merchandise exports would have increased nearly $2 billion.

Trade in services, like trade in goods, is impeded by many obstacles. Some examples:

Brazil requires that all accountants hold a professional degree from a Brazilian university.

In England, foreign air carriers are charged higher landing fees than domestic carriers.

Australia has a long-standing policy that prevents foreign banks from establishing branch offices or subsidiaries.

Korea restricts the entry and operations of foreign owned insurance companies. It also has a requirement that all local re-insurance be placed with the state-owned monopoly.

In Egypt, imports of motion pictures can only be made through state-owned commerical companies. No foreign films may be shown if Egyptian films are available.

Despite the work of the United States Trade Representatives in compiling a 200-page inventory of barriers to trade in services, including more than 8,000 citations, the Administration has failed to reduce these impediments. At the November, 1982 Ministers' meeting on GATT (the General Agreement on Trade and Tariffs), the Administration belatedly requested a commitment to a program of service trade liberalization. That effort failed, bringing only a general GATT invitation to member states to submit separate sector studies as a basis for possible future consideration.

While both bilateral and multilateral agreements on services should be sought as a matter of highest priority, it is obvious that they will take steady pressure and considerable time to achieve. States cannot wait, without action, for international procedures to work themselves out.

- *We therefore recommend that U.S. trade and trade remedy laws be amended to include international trade in services and afford this sector the full protection of merchandise trade. The President should be authorized to deny the issuance of any license, permit, order or other authorization that allows a foreign supplier of services access to the U.S. market if it is determined that the supplier's government discriminates against U.S. firms.*

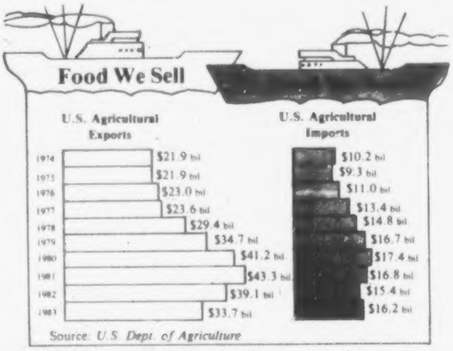
We also lack adequate data about services trade to help us develop realistic policy or negotiate reasonable agreements. There is currently no coordinated system to gather, process and publish international service industry data.

- *We recommend that the Economic Cooperation Council (described in the previous chapter) institute measures to collect information about U.S. and foreign firms necessary for the development of competitive U.S. policies on services and to research issues and problems facing services industries.*
- *Other U.S. laws, regulations and practices should be reviewed and amended as necessary to remove disincentives to the expansion of services exports. Those existing government institutions that provide export financing should be encouraged to consider service industries.*

Trade in Agriculture

American farmers are losing world markets. Projections for 1983 show farm exports at $33.7 billion, down 17 percent from the peak of $43.3 billion in 1981. The U.S. share of world trade in grains, our largest farm export, fell to about 53 percent in 1983 from the 1980 high of 60 percent.

Once considered the world's bread basket, we are slipping into a residual supplier's role. Other agricultural exporting countries offer our buyers lower prices, better credit terms, and greater confidence in delivery. These market share losses have serious implications for our farmers. They mean that U.S. agricultural exports will not necessarily rebound with a global economic recovery. Farm profits and competitiveness will continue to decline. With more than a million agricultural jobs dependent on exports, we need aggressive action to regain markets.



Source: *U.S. Dept. of Agriculture*

There are four major reasons for our losses in world agricultural markets. They are the overvalued dollar, made worse by the global recession and balance of payments problems of less developed countries; subsidies offered by our trading competitors; limited U.S. use of export credit and loan guarantee programs; and the perception that the U.S. is an unreliable supplier of agricultural goods.

In the extremely competitive world of agricultural trade, a slight price advantage can make a customer switch suppliers. Although domestic U.S. agricultural prices have fallen over the past three years, the overvalued dollar has meant that only a small fraction of the price decline gets to foreign customers. Even though the U.S. price of corn fell 25 percent between 1980 and 1982, the sales price of U.S. corn in Japan was almost unchanged.

The overvalued dollar puts a hidden tax on U.S. agricultural exports that foreign customers must pay. And our competitors get an automatic price advantage to help them win contracts away from American farmers.

More broadly, the imbalance in exchange rates contributes to lengthening the global recession and intensifying the balance of payment problems of many less developed and developing countries. As overall demand is held down, so is the market for agricultural imports.

At the same time, our competitors are using subsidies to undersell U.S. agricultural products. The European Economic Community and Japan are two of our best agricultural trading partners, but the subsidies of the EEC alone have cost the U.S. from $5 billion to $6 billion a year in exports. In 1982, the EEC devoted nearly one-third of its budget, $7 billion, to subsidizing its agricultural exports.

France sells poultry to the Mideast at 30 percent below what U.S. producers can offer. China puts canned mushrooms on sale in the U.S. at seven percent less than their domestic price. Vietnam is dumping rice. Italy is dumping pasta. New Zealand is dumping dairy products. And the list goes on.

Less developed and developing countries are huge untapped markets for our exporting farmers to exploit, but they cannot tap these markets without expanded export credit lines to those countries.

While its three-year, $1.5 billion program of blended credits is clearly inadequate as a match to our competitors subsidies, the Reagan Administration has also not adequately funded the concessional credit program under the "Food for Peace" program. Funding for this program, which has been credited with developing strong new commerical markets for U.S. agriculture has declined under the Reagan Administration. In fiscal 1983, funding for Title I and Title II of the program was $859 million less than the amount spent in either fiscal 1975 or 1976.

Embargoes, whether or not related to foreign policy sanctions, have been another cause of U.S. farm trade losses. In 1973, an oil-seed embargo was introduced that primarily affected soybean shipments to Japan. Although it only delayed shipments for a short time and did not cancel them, the embargo led Japan to develop a new soybean market in Brazil. Japan invested heavily in financing the farming operations and processing plants for the new industry and, as a result, Brazil soon became our major competitor in world markets. By 1980, when the U.S. imposed the grain embargo on the Soviet Union, Brazil was in position to take over soybean sales to the Soviet Union. We have not yet recovered that market.

One Administration response to our agricultural trade problems has been the Payment-In-Kind (PIK) program. Whatever its merits, compared to its costs, PIK has done little to dispose effectively of commodity surpluses and has been inequitable in its benefits. Not only has the program given a few farmers tremendous windfall profits while others suffer the full effects of crop-ruining drought, but PIK has decreased farm production and increased food costs. Although it has raised prices for some farmers, it actually impairs our ability to export by reducing production.

To ensure that U.S. agricultural exports regain their global dominance, to stimulate sales abroad and reverse the decline in U.S. market share, we propose:

- *Strengthened and expanded agricultural export promotion programs such as the export credit and loan* *guarantee programs under the Commodity Credit Corporation. We must also be more aggressive in creating an export market in commodities, like dairy products, where we have a domestic surplus and where international demand is great.*

- *Modifying the Food for Peace program to extend longer term intermediate credit for agricultural exports to developing countries. Extending credit for ten years, instead of the current three, would allow countries with balance of payments problems to accept our credit terms and to import more of our agricultural produce.*
- *Making clear that the U.S. fully intends to be a reliable supplier of agricultural goods. The Export Administration Act must preserve contract sanctity for agriculture. U.S. agriculture must be protected from needless export controls, both in the case of foreign policy controls and in the case of short supply.*
- *Negotiating aggressively with our trading allies for reduction of export subsidies and our reciprocal market entry. We should make it clear that the U.S. is not willing to lose its export market shares to unfair trading practices and that any violations will be brought to the GATT.*

Trade Laws and Organization

U.S. businesses are being seriously handicapped by unfair foreign trading practices including subsidized imports, dumping and non-tariff barriers. Almost 50 percent of all international commerce is conducted under some form of non-tariff restraint. Trade laws exist to deal with predatory trading practices that injure domestic markets. Properly defined and enforced, they could eliminate many of the import problems that our producers currently face. But the Reagan Administration has not interpreted or used our trade laws aggressively.

Trade Laws Ineffective

Our trade laws do not work against unfair trade practices. Under existing trade laws U.S. businesses face a series of roadblocks when they seek remedies. First, they must shoulder the enormous costs of bringing and sustaining their case. Second, many cases are decided on the basis of out-dated concepts that do not reflect the realities of modern international trade practices. Subtle new forms of subsidies have gained worldwide popularity but are not now covered by our trade laws. Third, even favorable decisions often bring too little remedy, too late.

Our trade laws also put roadblocks in the path of domestic industry seeking relief from injurious imports. The 1974 Trade Act, with its "escape clause" provision, was enacted primarily to help U.S. firms hit hard by import competiton. It also provides a trade adjustment mechanism, a potentially valuable incentive for labor and management to improve competitiveness of U.S. industries. But because the United States maintains a tougher legal requirement for relief than the standard GATT requires, the escape clause is seldom used.

While the Administration has recently been willing to provide temporary import relief, its actions have been haphazard. The Administration should pick cases to pursue by determining which offer the greatest gains for America's future competitiveness.

Temporary relief measures to help industries restructure should be tied to negotiations within the Economic Cooperation Council framework. We need to insure that such relief is granted only in exchange for industry commitments to reinvest to increase its competitiveness. Moreover, relief should be targeted to very specific product categories. Such assistance should be temporary, extended only under extraordinary circumstances.

The 1974 Trade Act also provides the President wide latitude in initiating retaliatory cases against unfair foreign trade practices. The Administration has brought many such cases to GATT. But GATT's dispute procedures are slow and inadequate, and the Administration has been much too unwilling to take unilateral action against predatory foreign trading practices. We must insist on improvements in the GATT dispute process, and we must take our own actions to make markets function on a more reciprocal basis in the meantime.

The Administration, with its misplaced faith in free market forces, has neither proposed meaningful changes in current trade laws nor applied them vigorously. That attitude has hurt U.S. companies and workers.

Many firms cannot make timely and effective use of our trade laws. Small businesses are particularly limited. Importing and exporting firms need technical assistance to help them substantiate their claims for remedy. Without such assistance, U.S. firms, in making their case to our government, carry an unfair presumption that they are at fault.

U.S. trade laws should also provide relief timely enough to prevent further injury. They should operate at a level of predictability that insures action will be taken. Their remedies should be effective and, to the extent practicable and advisable, coordinated with other aspects of industrial strategy.

We propose the following changes in U.S. trade laws:

- *Meaningful reform and aggressive enforcement should be our first priority in making our trade laws responsive to the needs of the U.S. firms. It is time that the U.S. drop its reluctance to assert the rights of our own trading firms in international competition and put the emphasis on fair trade.*
- *The U.S. should call for immediate negotiations with other trading nations to resolve three basic international trade problems. First, markets in some nations are not open to our exports. Second, some nations have industrial policies that invade our market unfairly. Third, we have no effective remedy to the problems of industries severely hurt by foreign competition. These negotiations should emphasize reciprocity and the openness of markets on a quid pro quo basis. Performance requirements, quotas, government procurement policies and other barriers to trade should be subject to these negotiations as well.*
- *These talks should reach well beyond discussions of tariffs. They should also cover industrial policies and subsidies that restrict access to markets.*
- *Trade law definitions should be broadened to include targeting and other newer forms of unfair trading practices beyond simple subsidies or dumping. Many foreign nations are using new, predatory practices, which are not covered by existing trade laws.*
- *The legal determination accompanying a finding of injury under Section 201 of the Trade Act of 1974, the "escape clause" provision, should be no more stringent than the GATT standard. Escape clause relief also should be tied to industrial strategy.*
- *A continuing program should be established to monitor and analyze the industrial policies of foreign countries to discover whether targeting subsidies are being planned or implemented. This sophisticated program of international industrial analysis should be conducted by the Economic Cooperation Council.*
- *An advocacy office should be established to assist the public with information on remedies and benefits available under the trade laws. This would help to ensure better, more effective use of our trade laws.*
- *The federal government should provide special assistance to small businesses in filing petitions and applications for trade law remedies. The Reagan Adminsitration has devoted almost no attention to the special needs of small businesses. Because they lack resources needed to research and finance a trade petition, many small businesses have been very badly injured by predatory practices.*
- *An appropriate benchmark should be established which relates to market prices in the U.S. It is very difficult to assess duties for dumping by non-market governments. There is no fair market price in the home market which can be reliably used to determine dumping margins, and a better system is needed against injurious non-market imports than the present "surrogate country" approach.*
- *Present anti-dumping and countervailing duty laws also must be improved to include more workable and effective standards for determining threat of injury. Because the laws are meant to deter unfair trading acts, a clear threat test is essential.*

Through such a test, unfair trading practices could be stopped before injury occurred, a very significant improvement over present criteria. Threat should mean the reasonable probability of injury within the foreseeable future. A threat finding should not be so difficult to obtain that it is indistinguishable from a finding of present injury.

- *The current practice of permitting settlements in countervailing duty cases — either in the form of quantitative agreements or offset agreements — should be significantly curtailed. These settlements do not provide for elimination of foreign subsidy and therefore permit continued unfair imports.*
- *The courts should hold off their review of trade cases until after final action by the Commerce Department. Current practice is time-consuming and costly and, in most cases, the court can make its review just as easily after final agency determination. Advance judicial review of these cases should be prohibited until after the agency's decision has been made.*
- *The method for releasing confidential information should also be standardized to make filing for information less costly and time-consuming.*
- *Finally, the Supreme Court decision regarding the legislative veto endangers the appropriate balance which must exist between the Executive and Legislative branches of government in the evolution of trade policy. An effective mechanism must be available for timely congressional oversight of Executive branch trade decisions.*

Trade Reorganization

The Reagan Administration has attempted to substitute trade reorganization for a realistic and coherent trade policy. The effort is short sighted. Certainly, proposing a new federal agency and rearranging bureaucratic functions do not, in themselves, create effective trade policy. The diverse departments and agencies involved in the formation and execution of trade policy must be forcefully led and effectively coordinated. The Reagan Administration has failed to do either. A Department of Trade cannot substitute for a clear trade policy and the strong leadership necessary to carry it out.

Trade reorganization can only have meaning when it embodies and carries forward a commitment to develop and implement a trade strategy along the lines presented in other sections of this report. Once a comprehensive trade policy is established, a rational trade reorganization plan can contribute significantly to the goal of making the United States competitive in international commerce.

Trade reorganization should conform to the following guidelines:

- *Any trade reorganization plan should include an explicit mandate to seek expanded world trade. The head of a new trade department should also be made chairman of the board of the Eximbank and Overseas Private Investment Corporation.*
- *Any reorganization plan should focus on long-term solutions to our trade problems, incorporating measures to increase productivity and revitalize U.S. businesses. Small businesses engaged in international trade should have special assistance to ease their international operations.*
- *The International Trade Administration should retain primary responsibility for development of commercial trade policy and such activities as export promotion, trade administration and export controls.*
- *The Department of Agriculture should be given primary responsibility for agricultural trade policy.*
- *The White House should retain overall responsibility for trade policy and trade negotiations. Leadership on commercial and agricultural trade policy within the Executive Branch must be clear and forceful.*
- *Economic Cooperation Council recommendations should be fully integrated and coordinated with commercial trade policy. While government now provides no coordination between trade and industrial strategies, the link between the two is clear. It should be recognized within any reorganization. An office for commercial competitiveness and productivity could implement ECC policy recommendations.*
- *The special relationship that currently exists between congressional committees and those in the Executive Branch responsible for trade negotiations should be fully maintained.*
- *Reform of the current personnel system in the International Trade Administration should be considered. The foreign Commercial Service should be expanded to include relevant policy positions inside the United States. The establishment of a career service for international trade would be a significant and positive step.*

The Foreign Service Commercial Officer Corps of the Department of Commerce is an important resource for export promotion. Based in 68 countries around the world, these officers can provide vital counseling and assistance to small and medium-sized American businesses seeking export opportunities.

The corps is undersized, however. It requires improved training staff support. The United States currently has 185 officers based overseas, compared to 345 for Japan, 350 for England and 365 for Canada. Even Brazil has 189 such trade diplomats and Australia has 171. In 1982, Foreign Service Commercial Officers assisted 5,000 American businesses to enter foreign markets for the first time, generating $1.5 billion in exports. A modest investment in increasing the size and improving the quality of the corps would bring a significant return in increased U.S. exports.

Trade Adjustment

The Reagan Administration has simply disregarded the devastating effects of our trade deficits on American workers, especially women, minorities, the less-skilled, and those who are dislocated by imports and ill-equipped to move rapidly or easily to other jobs. By failing to design a coherent trade adjustment strategy the Reagan Administration has put the future of these workers in jeopardy.

Our economy is in the midst of a tremendous transition, powered by changes in technology and in the global economy. Many experienced workers are losing their jobs as employment moves from key U.S. manufacturing sectors to countries where the labor force is less skilled and less well-paid. Many U.S. workers find that when they lose their jobs they cannot quickly acquire different skills and new jobs. Often they have very little idea of how to find a new job, what skills are in demand and how to learn them.

In these circumstances government, business, unions, and schools must provide some form of trade adjustment assistance — the necessary counseling, skills development, and placement aid to steer dislocated workers into new employment.

Programs to help workers adjust to new circumstances and industries adjust to new competitive challenges must be part of the industrial strategy outlined in a previous section of this report. The Economic Cooperation Council should be in a position to aid in adjustment both where injury has already occurred and where new competitive challenges can be anticipated.

The Reagan Administration believes that American workers will only make the necessary adjustments if they are left on their own to feel the full pain of transition. Rather than eliminating trade adjustment assistance, as the Administration proposes, we should reform it. We should make it more responsive to the needs of workers and industries hurt by international trade.

Dislocated workers are a valuable economic resource — men and women who can be productive again. Adjustment programs must make adequate support systems available for workers in training for, and transition to, new employment.

The Trade Adjustment Assistance Program in the Trade Act of 1974 was a fundamental element in a compromise that led American workers and their unions to support elimination and reduction of trade barriers against imports, and acknowledgement that workers who lost their jobs due to increased imports were owed some assistance to weather the transition and to develop needed skills for the future. Yet this Administration has tried to eliminate that program.

Instead of assistance, displaced workers have been left with broken promises. A political agreement on which our trading system is based has been breached.

To solve the problems of dislocated workers, we need to develop programs that build on our natural competitive advantage in high value-added production. We need skills development programs that will equip workers for jobs with a future. We need to encourage businesses to expand production in the U.S. instead of exporting jobs to foreign countries. We need to encourage industries to make products less vulnerable to low-wage competition and to encourage industries to modernize. We need, in short, to help American workers to prosper, to benefit from the current economic transition. We cannot leave Americans jobless, behind the rest of the world's workforce.

ESTIMATED NUMBERS OF DISLOCATED WORKERS IN JANUARY 1983 UNDER ALTERNATIVE ELIGIBILITY STANDARDS AND ECONOMIC ASSUMPTIONS (In Thousands)

Eligibility Criteria	Number of Workers High Trend	Number of Workers Middle Trend	Number of Workers Low Trend
SINGLE CRITERIA			
Declining Industry	1,590	1,290	1,240
Declining Occupation	2,200	1,780	1,700
Ten Years or More of Job Tenure	1,020	870	840
More than 45 Years of Age	1,370	1,160	1,120
More than 26 Weeks of Unemployment	1,200	865	840

Source: *Congressional Budget Office*

- *We must reorder our priorities. The well-being of the American people and their standard of living must become a top priority of U.S. trade policy.*
- *Incentives must be created, and disincentives eliminated, to encourage U.S. businesses to remain in the U.S. and to expand their production and employment at home.*
- *With high unemployment, severe worker dislocation, and many former jobs eliminated for good, the federal government should provide national information on available training programs and job opportunities. A standardized computer job bank should match workers with job opportunities and let workers know what skills they need to meet the needs of changing industries.*
- *Employment service offices should provide early counseling, job search assistance, job banks, and other services to dislocated workers. Unfortunately, at a time when Americans are losing their jobs to import competition, the Reagan Adminsitration has attempted to cut the job placement and other services of the employment offices nearly 50 percent. Only when it became apparent that 1,000 of the 2,600 employment service offices would have to be closed did the Administration agree to restore some of the funds. Employment assistance programs are a sound investment in our workers, and it is counterproductive to withdraw the helping hand when workers need it most.*
- *The Trade Adjustment program should be fully implemented — not to provide make-work — but to offer jobs with a future and help dislocated workers develop the skills needed for such employment, to keep such men and women permanent, productive members of the workforce. Properly funded and backed by the federal government, this program should focus on skills development and the goal of secure employment.*

Its scope should extend to workers in two new categories: to those who lose their jobs with firms supplying essential parts or services to import-beleaguered industries and to those whose jobs disappear when their employer relocates production facilities abroad. Trade adjustment retraining benefits at increased levels of funding should also be extended to give workers enough time to search for and move to new jobs, to choose and complete retraining programs, so that stringent time limits do not bar workers from learning the new skills actually in demand.

- *A special Treasury account should be established, funded from a percentage of customs duties, to carry out both worker assistance and industry restructuring programs. The latter, guided by the Economic Cooperation Council, should provide increased help to single firms for new product or process development, for export development, and for improvement in overall ability to compete against imports as well as industry-wide technical assistance in those industries where a substantial number of workers are eligible for trade adjustment assistance.*
- *A separate revolving account giving priority to research and development should be established to channel loan payments and other receipts from firms into further loans and guarantees and technical or other adjustment assistance.*
- *Efforts to support skills development courses, adult education, vocational education and certified company-run training programs should be encouraged.*
- *Work sharing for workers in declining industries could also permit workers to receive unemployment compensation for a few days a week while they develop new, needed skills. In some cases, living allowance stipends may be needed to permit workers, particularly those with dependent families, to take the time for retraining.*
- *Junior and community colleges are ideal settings for many skills development programs. Facilities already exist, and with matching government financing, may readily be made a great asset to skills development programs in many communities.*
- *Removing legal barriers which inhibit Private Industry Councils from sponsoring skills upgrading programs through existing educational institutions would also be a positive step.*

In strengthening our adjustment programs, we should seek to anticipate change. We should respond before situations reach the critical stage, before hundreds of workers are laid off, and before entire communities fail because of our import-export imbalance. We should provide incentives for private employers to anticipate layoffs and to approach the government for helping in placing workers in new jobs and in developing trade adjustment programs before the industry is badly hurt. Forward-thinking private management and public policies are essential to avoid much of the hardship and most of the permanent harm imports can do to our industries and our workers.

Conclusion

The United States is facing an era of transition in our economy unlike any we have yet experienced. We are truly in the midst of a second industrial revolution, one which is driven by visibly rapid changes in technology. International trade has become a vital component of our future economic progress. As a nation, we have a choice. We can lay the foundation now and meet the challenges that await us. To do so means economic growth, jobs and a higher standard of living. To ignore the future, to go on as we have, insures economic stagnation.

Democrats believe in the future of this country and for that reason support a positive, aggressive strategy for making American competitive in the world marketplace.

In this report, Democrats have recommended such a strategy — a strategy that responds to the realities of today's world economy.

- *An active approach for resolving exchange rate imbalances that have resulted in a subsidy on every foreign import and a tax on every American export.*
- *An industrial strategy for making American industries more competitive in the world economy.*
- *An export promotion plan that provides American business with the necessary tools to meet the competition in the international marketplace.*
- *Reform of U.S. trade laws that will result in a more level playing field for American firms in international competition and government agencies and are well organized to meet the challenges ahead.*
- *Programs to provide American workers and firms with tools they will need as they adjust to the future.*

Mr. LUNDINE. The United States is absolutely dependent on an international trading system for our future life blood. We must be capable of penetrating foreign markets and competing with others here at home as well as abroad.

Factors like the scope and breadth of the international debt crisis are certainly hindering our ability to trade more effectively. We lost 400,000 jobs in 1982 and 1983 according to most estimates, simply because we couldn't export to the debt-ridden Latin American countries as we had in the previous decade.

Another related economic factor which you have heard much about and is inhibiting our trade is the over-valued dollar. Fiscal and monetary policies pursued particularly since 1980, have kept real interest rates high in the United States, therefore attracting foreign capital here.

This has the result, of course, of making U.S. goods more expensive abroad and foreign imports cheaper.

A second international reality we must face is the growing effort on the part of many of our international competitors to develop and implement government-backed industrial strategies to promote productivity performance and win world markets in key sectors.

The United States is lagging behind in productivity performance. About that I don't think there is any debate. Of all the industrialized countries, our increase in productivity, in manufacturing, is lower than any other. It is true as well that we have lost world markets shares in virtually every category of manufactured products.

From 1970 to 1980, we lost world market shares in such areas as aircraft, electronics, machine tools, semiconductors, and automobiles. It ranges from high-tech products to basic industries. It is an across-the-board phenomena, and it is not shared by all of our international competitors.

The United States is the only major industrial country without a coordinated industrial strategy. I think the alternative to developing some sort of a private sector/public sector partnership in these matters is going to inevitably be increasing protectionism in an effort to solve our problems to some degree.

I am not for any centralized planning that tries to identify the technologies of the future. It does seem to me though that the private industry and Government could come together in a more sensible way and attempt to coordinate everything from antitrust to tax policy in a way that in general would be more conducive to our competitiveness.

While all of the industrial strategies abroad have not been successful, they nevertheless, as an aggregate, pose a serious threat to American industries. Taken together, they could succeed in undermining our capacity as a nation to maintain a viable industrial base.

Japan may succeed in automobiles and electronics; Korea in steel; some European Community countries in specialty steels and aircraft, and the sum total is that the United States has lost its preeminence in every one of those products.

Given this reality of international competition, I don't think we can rely on traditional gimmicks frankly, such as always resorting to a tax break in order to try to get some particular kind of performance in the private sector.

Without a strong manufacturing base, the United States cannot prosper. We must develop some sort of an industrial strategy to work for us. Mark Twain spent a good amount of his life in my district in Elmira, NY, and I found where he once even identified the problem. He said, "We cannot all make a living taking in each other's wash."

I think the point is that we are not going to all make a living running fast food restaurants.

If the United States is not a leader in machine tools, in aircraft and in other manufactured products, high technology and basic industry as well, we are not likely to have a growing economy and a higher standard of living.

A third cause of our trade deficits is one that this subcommittee has addressed, and I think very, very incisively, already, and that is the ineffectiveness of many of our trade laws in countering violations by our trade competitors.

While I am not going to spend a lot of time on this, because you have already addressed it to a large extent, I want to identify it as a serious problem, particularly for small business that doesn't have this enormous legal capability of arguing very complicated cases, and developing appropriate remedies over an extended period of time.

A fourth cause of our trade deficits, in my judgment, is our inability to promote exports abroad to a greater extent.

Now we have to address the problem of export controls which I have heard you already discuss. We have to continue our support for competitive financing through the Export-Import Bank and other mechanisms, only to meet competition. I would rather we didn't have any subsidized financing if our competition didn't either, but I think we have to be fully prepared to meet that competition, to assure that we don't lose sales abroad simply on the basis of financing.

We have to, in general, both in the private sector and in our Government policies, be more export oriented. Small business in particular should be encouraged to take advantage of new export opportunities. I just recently had an idea that maybe we could put some retired business executives with experience in international business to work on a volunteer basis trying to help sort out some of the problems of small business. I think there are essentially private sector approaches to get our private enterprise more export oriented, but I also think that there are Government policies that we should look at.

For example, since I am before the Ways and Means Committee, I think we should assess the impact of foreign countries rebating all of their value-added taxes as soon as their products are exported while American taxes are imbedded into the cost of that product, whether it is exports or it is competing in the United States.

I don't know the answer to that problem quite frankly, but this tax-writing committee I think should look at it not just in terms of what makes sensible tax policy, but what is going to provide an environment where American industry and American private enterprise can compete successfully abroad, and particularly can improve our export policy.

This trade task force, which I had the privilege of cochairing, led us to conclude that our trade deficit has aspects that must be addressed through Government actions in collaboration and coordination with the private sector. We believe that the world of tomorrow will be vastly different from yesterday. We don't fear that change.

In fact, we think that the policies of the Government and the initiative of the private sector ought to be geared more toward making that a smooth transition, taking sensible policies in coordination with one another, to make sure that our standard of living is raising.

This report I think identifies some of the important steps which must be taken, and contains some innovative policy approaches worthy of more extensive examination. I thank you very much for the opportunity to appear before this committee, and I would be happy to respond to any questions.

[The prepared statement follows:]

STATEMENT OF HON. STAN LUNDINE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

I want to commend this Subcommittee for holding these hearings on our trade deficit. We cannot afford to ignore the trend in our trade accounts. Our trade deficit is the scorecard of how well we are competing internationally—and our scorecard is not encouraging. As recent as 1970, the United States had a surplus in its merchandise trade deficit. This year the merchandise trade deficit is expected to reach $110 Billion.

Our relative competitiveness internationally translates into jobs for our people and determines whether or not we are able to provide a rising standard of living for Americans. Every $1 Billion in our trade deficit represents 25,000 jobs which are lost or not created. This means that if, as expected, our merchandise trade deficit reaches $110 Billion this year, we will have lost opportunity for 2,750,000 American jobs.

Very simply, then, this is the reason our trade deficit matters. Improving our trade balance means jobs for our people and opportunity through an expanding economic pie.

I believe that the causes of our trade deficit are deep-seated and complex. They involve international economic conditions, actions taken by our trading competitors working with their governments, the conduct of fiscal and monetary policy in our country, and many individual factors impacting on different sectors of our economy.

Last year, I was asked by Gillis Long, Chairman of the House Democratic Caucus to Co-Chair a Task Force on International Trade in an effort to develop recommendations on trade policy for our country. Over the better part of a year, the members of that task force met with private sector leaders involved in international competition, as well as with trade experts and worked to identify a trade strategy for this country. The principal causes of our trade deficit were identified by our task force. After many long hours of deliberation, we also developed many action-oriented recommendations to deal with these underlying causes of our trade deficit. With the permission of the Chairman I'd like to submit the entire text of our final report into the hearing record because I think it will be useful in your future deliberations.

We must first understand the reality of the modern day trade situation. Seventy percent of all U.S. goods are now in competition with foreign made products here or abroad Given this, the United States is absolutely dependent on the international trading system for our future life blood. We must be capable of penetrating foreign markets and competing successfully with others here at home.

Factors likes the scope and breath of the international debt crisis are hindering our ability to trade more effectively. Third world nations now owe more than $600 Billion to foreign lenders. To earn the currency to repay this debt they must import less and export more. Export trade was the major force behind U.S. economic growth in the 1970s and the developing nations provided the fastest-growing markets for U.S. manufactured goods and farm products. In 1982 and 1983, it is estimated that we lost 400,000 jobs because we could not export to debt-ridden Latin American countries as we could in the previous decade.

Another related economic factor which is inhabiting U.S. trade is our over-valued dollar. The fiscal and monetary policies which have been pursued particularly since 1980 have kept real interest rates high in the United States, thus attracting foreign investment to U.S. shores and increasing the value of the dollar on international markets. This, in turn, makes U.S. goods more expensive abroad and foreign imports cheaper in the United States. Coordinated action is needed to bring our $200 Billion federal deficits down and to bring interest rates down. The perpetuation of such ill-advised fiscal and monetary policies will continue to exacerbate our trade problems.

The second international reality we must face is the growing effort on the part of many of our international competitors to develop and implement government-backed industrial strategies to improve productivity performance and to win world markets in key sectors.

The United States is lagging behind Japan, France, Italy, and Germany in manufacturing productivity performance. In the decade of the 1970's before the onset of the international debt crisis and throughout periods of over-valued and undervalued dollars, the United States lost world market shares in almost all categories of manufacturing—in critical areas such as aircraft, electronics, machine tools, semiconductors, and automobiles.

The United States is the only major industrial country which does not now have a coordinated industrial strategy. Japan, West Germany, France, Great Britian, Sweden, Denmark, Italy, and even Ireland and Austria are all practicing brands of industrial strategies to win markets. Some of the emerging nations, as well, realize the importance of industrial strategies and are beginning to capture large market shares—nations in the Pacific like South Korea.

While not all of these industrial strategies will be successful, they nonetheless pose a major challenge to our nation's industry. And, taken together they may very well succeed in undermining our capacity as a nation to maintain a vibrant industrial base. While Japan may succeed in autos and electronics, Korea may do so in steel, the European Economic Community countries in aircraft and speciality steels, etc.

Given this reality of international competition, the United States can no longer rely on traditional approaches to international trade. And, we cannot afford to passively sit by and simply observe our industrial decline. Without a strong manufacturing base, our economy cannot prosper. We must develop an industrial strategy which can work for us. As Mark Twain once said, "We cannot all make a living taking in each other's wash."

A third cause of our international trade deficits, I believe is the ineffectiveness of many of our trade laws in counteracting violations by our trading partners of internationally-agreed upon rules for the conduct of trade. Our trade laws all too often offer our industries too little, too late to have much impact on international trade flows. This subcommittee is to be commended for the effort you have made during the past year to reform our trade laws to make them more effective within the realm of the very difficult international trading climate we face today.

A fourth cause of our trade deficits, I would identify, is our inability to promote our exports abroad more aggressively. There are many obstacles to exporting which I believe must be removed. We need a strong Export-Import Bank, attention to the needs of small business as they attempt to export, reasonable export controls with a minimum of bureaucratic involvement, and specific attention to the problem of trade in services and agriculture. Without these efforts, we cannot be an effective exporting nation in the future.

American industry and government should be much more export oriented than we have been in the past. Small business should particularly take advantage of new export opportunity. Government should assess the impact of foreign countries rebating value added taxes upon export where all U.S. taxes are included in the sales cost of competitive products.

The deliberations of our trade task force led us to conclude that our trade deficit has several aspects which must be addressed both through government actions and in cooperation and coordination with the private sector. We believe that the world of tomorrow will be vastly different from the world of yesterday. The United States is no longer in the preeminent world economic position we once occupied. Instead, economic power is diffusing throughout the world in many, yet to be understood ways. If we do not deal with the underlying causes I have talked about, the inevitable result sooner or later will be widespread trade protectionism which will ill serve our own and the world's economic interests.

We must have lower budget deficits and interest rates, a stable international banking system, and a positive industrial and exporting strategy. In addition, we must do everything possible to devise effective trade laws which can help make progress toward a more open international trading system.

These are not easy tasks. Achieving them will mean that we must discard many traditional views both here and abroad. We will need new institutions and working cooperation between the government, business, labor, and others to achieve our goals. I believe our trade report identifies some important steps which must be taken and contains many innovative police approaches worthy of more extensive examination by this and other committees of the Congress. I appreciate the opportunity to have this dialogue with you today and look forward to continuing to work with you in the future.

Chairman GIBBONS. Thank you. I am glad you brought up the item of the rebatability of the value-added tax versus the nonrebatability of the income tax. Whatever American negotiated that in GATT some 40 years ago deserves some kind of remembrance in history. I don't know who did it, but it has to be one of the monumental flops of all time. We are stuck with that, and we can't find anybody that wants to negotiate it out but us. That is the problem. We haven't been able to get any negotiating tool which is large enough to pry loose from that mistake.

I have heard economists go on for hours explaining how it really doesn't make any difference, it all washes out in the value of the currencies and everything else. I don't know enough economics to say that they are wrong, but I know the psychological advantage.

If it is only psychological it is still one whale of an advantage. I have gone through the transactions a number of times on specific items about rebating of the value-added tax. It is a relatively simple thing for anybody to do. It is a substantial savings in the purchase of a product. It may not make good political sense for goods that are consumed outside of your country not to have to pay some of the cost of government.

I have heard that argument too, but if we are going to work in an environment in which the playing field is level, it seems to me that we are eventually going to have to move to some kind of tax system ourselves that is GATT-compatible and is rebatable, or else we are going to have to continue coming up with gimmicks like DISC and FSC, and things of that sort, hoping that we can get them past the GATT. It is a real problem.

I want to commend you for the fine intelligent leadership that you provided to the task force that you headed. You showed a great deal of knowledge, skill, and patients in dealing with all the conflicting views that were presented to you, and you made Solomon-like decisions in working these matters out. I commend you and wholeheartedly support what you have advocated here.

Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman. I too would like to compliment our colleague. Thank you, Stan, for your testimony. I presume that the document that you have produced is not a partisan document, or is it?

Mr. LUNDINE. Yes, it is.

Mr. SCHULZE. It is?

Mr. LUNDINE. Actually it's kind of interesting, I think our theory was, that in a lot of parliamentary governments, the party out of power spends its time passionately arguing about issues and what should be their policy. We don't really have much of a mechanism in our democracy for that kind of thing, and we thought in the Democratic Caucus that it might be challenging. When the chairman complimented me for all those virtues, I think patience was a larger one than knowledge or anything else, and so it is a partisan document. But it was a deliberate attempt in the area of trade to try to say this is what we stand for, and I don't think so much in an accusatory way as in a way that defines some positions.

Mr. **Schulze**. Sometimes it is good to have two fairly partisan positions, because you find the truth is somewhere in between.

Mr. **Lundine**. Well, Ed Zschau and I have found that being supposedly on the opposite sides of this industrial policy debate, that when we talk we find that we are a lot closer, and that the differences between us are often differences of words and concepts more than they are practical reality.

Mr. **Schulze**. Thank you, Stan. Thank you, Mr. Chairman.

Mr. **Lundine**. Thank you.

Chairman **Gibbons**. Mr. Downey.

Mr. **Downey**. I join the voice of accolades. I too spend a lot of time in Elmira, probably for different reasons than Mark Twain did. When I was going to college it was a frequent watering hole where there were far more females than there were males. We went up there often. I got to know Mr. Lundine's district well.

Let me ask you, Stan, in particular about a problem that will be facing this committee, that has been brought to a number of us by the people in the steel industry who are actively seeking to have quotas and some other protectionist measures to provide what they consider to be some breathing space for reindustrialization so that they can compete in the future. What would be your view? I don't know if you have had a chance to take a look at what their interest is.

Mr. **Lundine**. Rather than commenting on the individual bill, which I will say although a member of the steel caucus I am not a cosponsor, I would rather say that in general principle the reason I talk about industrial strategy as opposed to policy is that I don't think the United States should pick winners and losers. I truly do not. Nobody of private and public sector together, certainly not the Government itself, should identify technology, but it is no secret that the products that have greater value added to them are those in which we are likely to compete better, and it probably was an intelligent decision by the President to put the quotas on specialty steel.

I think there was probably some unfair trading, particularly by our European trading competitors in that area. But if you are going to talk about quotas or other quantitative restraints on steel in general, I think we ought to get some back. Four times since 1968, one way or another we have given the steel industry some kind of protection from foreign competition. Never have we gotten a promise back of what they would do in terms of investment, jobs, prices, or whatever.

It seems to me entirely reasonable. I am not a knee-jerk protectionist nor a knee-jerk free trader.

I think these things have to be negotiated domestically as well as internationally and if the steel industry wants some particular advantage, I want to know whether they are going to put the funds that are generated by that protection into reinvestment in steel plants or into buying retail stores or oil companies or whatever.

Now, if that is more of Government reaching in, I guess that I feel we have got to do that, but it seems to me that we have got to establish some kind of an opportunity for discussion.

I would frankly be opposed to an out and out limit quantitatively on the amount of steel that can come into the United States without some kind of mechanism to tell us what we get back in terms of these factors that are so important to our long-range competitiveness.

Mr. DOWNEY. If there was a requirement for reinvestment, would that be enough or would it have to go further?

Mr. RIDGE. That would certainly make it more attractive and interesting.

Mr. DOWNEY. May I just observe to my colleague from Pennsylvania that the thesis is the foundation of the Communist dialectic but I suspect that that is just a coincidence.

Mr. SCHULZE. I agree with the gentlemen, but I might say that in this instance, when we are talking about between the Democratic Party and the Republican Party, I don't think we are going to end up close to Marx.

Mr. DOWNEY. If it is close to Marx, it is probably Groucho.

Thank you.

Mr. SCHULZE. If it is close to Marx, you win.

Chairman GIBBONS. Mr. Pease.

Mr. PEASE. Thank you, Mr. Chairman.

I would like to commend my colleague for excellent testimony. It is very, very helpful.

I am glad you raised a question about the rebatability of the value-added tax because that is an issue that I think we need to deal with. I am not convinced that it really makes a difference, but I think we ought to know whether it does or not. There are some people in the United States who use the rebatability of the VAT as an argument for the United States to change its tax system away from income taxes and toward VAT, or just to use the VAT as a primary vehicle for reducing Federal deficits.

I have been concerned about the possible regressivity of a value-added tax. I am wondering if you have any thoughts about the tradeoff between regressively in the VAT and any advantage you might get in terms of our exports.

Mr. LUNDINE. Well, that is a big subject. First of all, I believe that we have an opportunity next year and in the next few years to consider and possibly achieve tax reform that has been bothering me ever since I came here early in 1976.

I really do think that the crisis that this country phase in terms of our fiscal posture is such that we may be able to do things that were hardly achievable in the atmosphere that we have been legislating in ever since you and I have been members of this body and among the possibilities certainly will be discussed some value added kinds of approaches.

As you know, there are several currently at least in the discussion stage.

I have the same reservation as the gentleman from Ohio, that I am very concerned with whether they are regressive and, furthermore, I don't think you can compare the United States to Europe or other countries because you have to realize that a big part of the taxation in this country is at the State and local levels where they generally rely somewhat on sales tax revenue, and I think you have to look at that as a whole, but I know that some economists and others argue. One is Lester Thoreau from Massachusetts Institute of Technology that there are ways to structure a VAT if that is how you want to raise income tax, but then raise any additional revenue you want to raise without violating the principle of progressivity in your entire tax structure.

If you really need to know how to do that, you will have to ask Les Thoreau, not Stan Lundine, but there are some who argue that that is at least theoretically achievable.

Mr. **Pease**. Thank you very much.

Thank you, Mr. Chairman.

Chairman **Gibbons**. Thank you, Mr. Pease.

Thank you, Stan. We appreciate it.

Our next witness is Mr. Thomas J. Ridge, a Member of Congress from Pennsylvania. We welcome you here. We appreciate your patience in waiting and the time it takes to prepare your remarks and do all this.

We need your help.

STATEMENT OF HON. THOMAS J. RIDGE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA

Mr. **Ridge**. Thank you, Mr. Chairman. It is a pleasure to appear before you and your subcommittee.

Given the State of Pennsylvania that I am proud to be a lifelong resident of, and unique problems of a district——

Chairman **Gibbons**. You certainly have had unique problems in Pennsylvania. My heart goes out to the State and to its people. They certainly have been caught in a vast change. There perhaps has not been enough adjustment made available to them.

Mr. **Ridge**. You are right.

The focus of the hearing is on the international marketplace and the trade deficit. If there is any single cause of the difficulty that the people in Pennsylvania have experienced, it has to be related to the international marketplace. With the opportunity of the past year to listen to all the testimony on industrial policy as a member of the Banking Committee, and listen to Chairman Volcker and other economists talking about the interrelated nature of the internal budget deficit and the external trade deficit, that we have mutual causes, many of which are interrelated, I certainly do appreciate the opportunity to appear before you.

Mr. Chairman, I do request that the full text of my testimony be included in the record.

Chairman **Gibbons**. Yes, it will be, Mr. Ridge.

Mr. **Ridge**. Fully one job in six in my district is directly related to exports. Indeed, several of our largest employers sell sizable shares of what they produce on the world market.

In 1981, the last year for which figures are available, Pennsylvania firms sold 8.1 billion dollars' worth of goods on the world market. Of that amont, $2.8 billion was sold by 849 firms in the western part of our State, which I represent. Some 315,000 Pennsylvanians were employed by those firms to produce those goods.

Clearly, international trade is important to many of the firms in my district and their workers know it. In Erie, for example, whether you work at General Electric building locomotives—and they just secured a substantial order to provide those for China—or at American Sterilizer making hospital equipment, you are probably all too aware that the loss of steady orders from overseas may soon mean the loss of your job.

On the other hand although no reliable figures exist, I can say with some confidence that while one in six jobs in my district is directly related to exports and export markets, at least one in six of the jobs that have been lost in my district have been lost to imports.

Thousands of my constituents are employed, and thousands more used to be employed, in the machine tool industry, in the metal fastener industry, and in dozens of other firms heavily dependent on steel, and heavily damaged by foreign imports.

Last year alone, for example, 36 percent of the machine tools purchased in this country were purchased from foreign suppliers, many of whom were heavily subsidized by their own governments.

So I am sure it will come as no surprise to you that I am often asked by my constituents why we cannot just lock our doors to foreign imports, and throw away the key?

The answer, as you know, and as you have reminded Members of the House during your many years of service in this body, is that the doors of international trade open both in and out.

And, of course, doors through which no imports pass inevitably become doors through which no exports pass.

By locking our doors to imports, we would be locking our doors to many of the raw materials we now import to produce many of the things we make. And we would also be locking our doors to the largest untapped market for our goods left on earth: the world market.

I believe the way we end up putting all the unemployed people back to work is by increasing our exports. There are over 3 billion people who comprise the world market. The international marketplace is still an untapped market.

You have focused on the trade deficit and the problems, as I mentioned before. It is highly important to my State and to my district.

Mr. Chairman, I know that you have probably reviewed the Congressional Research Service linkages between our international trade activities and domestic economic activity, and I do not mean to be preaching to the choir, but for purposes of testimony I would like to highlight just a couple.

Chairman GIBBONS. Go right ahead because I think it really needs highlighting.

Mr. RIDGE. First, as U.S. imports from abroad declined during the recession of 1981 and 1982, recessions in many of our major trading partners also worsened.

Second, our trading partners' recessions reduced their ability to buy from us, thereby reducing our own output.

Third, high interest rates in the United States attracted considerable investment from abroad, thereby strengthening the value of the dollar on the world market, and making our exports less competitive, which further reduced economic activity here at home.

And, finally, as some of the previous witnesses have alluded to, the over-valued dollar contributed to a reduction in our domestic inflation rate, as the dollar price of imports declined.

Declining exports have had a dramatic impact on domestic budget deficits, and our exports have been declining steadily since 1980.

The testimony that I have prepared demonstrates that there is probably not one single sector that has remained unaffected by a declining share of an international marketplace. It is pretty much across the board.

Harmful effects, however, are not limited to the export sector. These effects are also being experienced by the domestic import sensitive industries. Again Pennsylvania is impacted severely. The steel industry, automakers, and the machine tool builders are major examples of domestic industries that have to compete with imports.

Following the Second World War, the United States went through a period of international trade dominance that has been called effortless superiority. There was little or no competition for many, if not most of the goods and services we provided. In the last two decades, however, this situation has changed dramatically.

Many of the major exporting firms now have to fight hard to compete in the international marketplace. Moreover, many firms that produce solely for domestic consumption must now compete against high quality, low cost imports.

The level of competition, both here at home and abroad, has changed drastically. There has been a noteworthy effect on interest rates. Continued high interest rates have attracted private capital from foreign countries. This has helped increase the value of the dollar on world markets, which has hurt our exports and increased imports. But there has been a beneficial effect, as well.

Chairman Volcker has alluded to it many times. A large part of this potentially disastrous national debt has been financed through foreign capital. The funds needed to finance the Federal debt, and to finance private investment has exceeded domestic savings. According to an estimate by the Federal Reserve Board, domestic savings may be supplemented by as much as 25 percent with foreign funds.

This is a very large sum of money,, and it comes from sources that are uncertain at best. As economic recovery spreads to other countries, some of the foreign capital may no longer be available to us here in the United States.

There will no doubt come a time when we are again forced to decide between monetizing the budget deficit and increasing the inflation rate, or raising interest rates. Neither of those options bodes well for the U.S. economy, either domestically or internationally. At some point we are going to be faced with the problem of reconciling this imbalance. When the day of reckoning comes, it will be exacerbated by the fact that interest and dividend payments to the net capital inflow necessarily increase future payments against the outstanding balance of payments deficit.

However, this is one of the most critical challenges facing Congress today.

Under the best conditions, the service surplus could not possibly offset the current deficits in merchandise trade balances, soon expected to reach $80 to $100 billion per year.

This means the current account balances will remain in deficit for the foreseeable future. The United States can no longer rely on the services balance to provide an overall surplus in our current account balances.

Mr. Chairman, I want to particularly commend you and the subcommittee for recognizing the problems in the trade deficit area and working so diligently to solve those problems. By conducting these hearings, to focus attention on the problem and examine possible solutions, and by drafting H.R. 4784, the subcommittee is providing the impetus to correct some of the fundamental causes of our trade deficit.

I was pleased to note the proposal for a Trade Remedy Assistance Office, and the program to monitor targeted subsidies in H.R. 4784. Those programs will help domestic industries faced with unfair competition from abroad. We have some of those firms in my part of Pennsylvania, so I applaud your efforts, particularly your proposal, and again I sound like an echo from some preceding witnesses to provide assistance for smaller firms by the appropriate trade agency when such firms are preparing and filing the petitions or applications necessary for trade relief.

Mr. Chairman, thank you once again for the opportunity to discuss this critically important problem here this morning. I look forward to working with you in the future in the all-important effort to help American industry regain its competitive posture, thereby contributing positively to the resolution of our current trade deficit problems.

Thank you.

[The prepared statement follows:]

STATEMENT OF HON. THOMAS J. RIDGE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA

Chairman Gibbons, distinguished members of the Subcommittee, thank you for the opportunity to appear before you this morning to discuss America's foreign trade deficit—an issue of considerable interest and concern to us all.

My own district, in the northwestern corner of Pennsylvania, could hardly be more sensitive to the ups and downs in our overall balance of trade with foreign countries. And we're affected not only by imports, Mr. Chairman, but by exports as well.

Fully one job in six throughout my district is directly related to exports. Indeed, several of our largest employers sell sizable shares of what they produce, on the world market. In 1981, the last year for which figures are available, Pennsylvania firms sold $8.1 billion worth of goods on the world market. Of that amount, $2.8 billion was sold by 849 firms in the western part of our state. Some 315,000 Pennsylvanians were employed by those firms to produce those goods.

Clearly, international trade is important to many of the firms in my district, and their workers know it. In Erie, for example, whether you work at General Electric building locomotives, or at American Sterilizer making hospital equipment, you are probably all too aware that the loss of steady orders from overseas, may soon mean the loss of your job.

On the other hand, Mr. Chairman, although no reliable figures exist, I can say with some confidence that while one in six jobs in my district is directly related to exports, at least one in six of the jobs that have been lost in my district have been lost to imports.

Thousands of my constituents are employed—and thousands more used to be employed—in the machine tool industry, in the metal fastener industry, and in dozens of other firms heavily dependent on steel, and heavily damaged by foreign imports. Last year alone, for example, 36 percent of the machine tools purchased in this country were purchased from foreign suppliers, many of whom were heavily subsidized by their own governments.

So, I'm sure it will come as no surprise to you, Mr. Chairman, that I am often asked by my constituents why we can't just lock our doors to foreign imports, and throw away the key? The answer, as you know, is that the doors of international trade open both in, and out. And, of course, doors through which no imports pass inevitably become doors through which no exports pass.

By locking our doors to imports, we would be locking our doors to many of the raw materials we now import to produce many of the things we make. And we would also be locking our doors to the largest untapped market for our goods left on earth: the world market.

Such a step would be penny wise but pound foolish, because as the members of this subcommittee well know, the loss of our export markets would cost far more American jobs than have already been lost—or will ever be lost—to unfair competition from abroad.

Nevertheless, we must deal boldly and decisively with out trade deficit problems, and we must deal with them now: because countless jobs are at stake, our industrial base is at stake, and America's place in the world economic order is at stake.

However, dealing with our trade deficit problems in a piecemeal fashion—whether industry by industry, firm by firm, or foreign competitor by foreign competitor—might be worse than not dealing with it at all.

Rather, Mr. Chairman, it is imperative, in my view, for us to deal with this problem in a comprehensive fashion . . . for, when problems are interrelated, their solutions must be, too.

The Congressional Research Service has outlined in some detail a series of linkages between our international trade activities and domestic economic activity.

First, as U.S. imports from abroad declined during the recession of 1981-82, recessions in the countries of many of our major trading partners also worsened.

Second, our trading partners' recessions reduced their ability to buy from us, thereby reducing our own output.

Third, high interest rates in the United States attracted considerable investment from abroad, thereby strengthening the value of the dollar on the world market, and making our exports less competitive, which further reduced economic activity here at home.

And, finally, the over-valued dollar contributed to a reduction in our domestic inflation rate, as the dollar price of imports declined.

Declining exports have had a dramatic impact on domestic budget deficits, and our exports have been declining steadily since 1980. Our merchandise exports dropped 15 percent in the 4th quarter of 1983 from the 4th quarter in 1980. Exports of capital goods dropped more than 25 percent, and exports of non-agricultural industrial supplies fell 20 percent. Even agricultural shipments were down 10 percent over that period.

From these figures, it's clear that U.S. exports were down pretty much across the board. The effect of the trade deficit and the strong dollar are being felt by our manufacturing industries, by agriculture, and by the service industries. However, the harmful effects are not limited to the export sector.

Those effects are also being experienced by the domestic import-sensitive industries, such as the steel industry, the automakers, and the machine tool builders. Other industries, too, have turned to Congress in recent years for various forms of trade assistance.

Following the Second World War, the United States went through a period of international trade dominance that has been called "effortless superiority." There was little or no competition for many, if not most, of the goods and services we provided. In the last two decades, however, this situation has changed dramatically. Many of the major exporting firms now have to fight hard to compete in the international marketplace. Moreover, many firms that produce solely for domestic consumption must now compete against high quality, low cost imports. The level of competition, both here at home and abroad, has changed drastically.

It can no longer be said that companies serving U.S. domestic markets are not engaged in international trade, because, as I said, even they face foreign competition. This competition has forced U.S. firms to look for ways to increase productivity and reduce costs. Unfortunately, some steps taken to compete with foreign firms have led to unemployment in areas like mine.

There has been a noteworthy effect on interest rates. Continued high interest rates have attracted private capital from foreign countries. This has helped increase the value of the dollar on world markets, which has hurt exports and increased imports. But there has been a beneficial effect, as well. A large part of our national debt has been financed through foreign capital.

The funds needed to finance the federal debt, and to finance private investment has exceeded domestic savings. According to an estimate by the Federal Reserve Board, domestic savings may be supplemented by as much as 25 percent with foreign funds. This is a very large sum of money, and it comes from sources that are uncertain at best. As economic recovery spreads to other countries, some of the foreign capital may no longer be available to us here in the United States. There will no doubt come a time when we are again forced to decide between monetizing the budget deficit and increasing the inflation rate, or raising interest rates. Neither of those options bodes well for the U.S. economy, either domestically or internationally.

At some point, we are going to be faced with the problem of reconciling this imbalance. When the day of reckoning comes, it will be exacerbated by the fact that interest and dividend payments to the net capital inflow necessarily increase future payment against the outstanding balance of payments deficit.

During the 1983 through 1985 period, it is quite likely that we will reverse the current account surplus that has accumulated since the end of World War II, and in all likelihood, the U.S. will become a net debtor country.

The largest economy in the world cannot afford to be a continual net debtor. If the U.S. has to rely on increasing amounts of foreign capital to finance our economy, we will ultimately sacrifice 2 major segments of our economy—the segment which depends on exports, and the segment that competes with imports.

At some point, this problem must be solved, or our system will collapse from a lack of support. The sooner this problem is addressed, of course, the better.

The trade deficit problems facing the United States are complex, and the solutions to those problems won't come easily. But finding, and implementing, such solutions is one of the most critical challenges facing Congress today.

The traditional strength of the U.S. trade balances has been a series of surpluses in the services balance which has more than offset our deficits in merchandise trade. In the last few years, however, this surplus has been decreasing, in part due to increasing competition from other countries.

But even under the best conditions, the services surplus could not possibly offset the current deficits in merchandise trade balances—soon expected to reach $80–$100 billion per year. This means the current account balances will remain in deficit for the forseeable future. The U.S. can no longer rely on the services balance to provide an overall surplus in our current account balances.

Mr. Chairman, I want to commend the subcommittee for recognizing the problems in the trade deficit areas, and working so diligently to solve those problems. By conducting these hearings, to focus attention on the problem and examine possible solutions, and by drafting H.R. 4784, the subcommittee is providing the impetus to correct some of the fundamental causes of our trade deficit.

I was pleased to note the proposal for a Trade Remedy Assistance Office, and the program to monitor targeted subsidies in H.R. 4784. Those programs will help domestic industries faced with unfair competition from abroad. We have some of those firms in my part of Pennsylvania, so I applaud your efforts, particularly your proposal to provide assistance for smaller firms by the appropriate trade agency when such firms are preparing and filing the petitions or applications necessary for trade relief.

Mr. Chairman, thank you once again for the opportunity to discusss this critically important problem here this morning. I look forward to working with you in the future in the all-important effort to help American industry regain its competitive posture, thereby contributing positively to the resolution of our current trade deficit problems.

Thank you.

Chairman GIBBONS. Mr. Ridge, I want to commend you for your very fine and very intelligent statement. Let me say I think you and I agree that our trade problem is really much longer than our subsidy trade laws. It is really the problem of the competitiveness of our economy. That is, we have run a monetary policy that has been in response to a fiscal policy. The fiscal policy having been in disarray, the monetary policy had to be overly cautious, and that has vastly exacerbated our problems in international trade.

I know of no State that has probably been hit more than your State. I regret that. I hope that we can find a solution to it.

Mr. RIDGE. Mr. Chairman, in every challenge there is also opportunity.

Chairman GIBBONS. Yes, there is, and I appreciate the kind words you had to say about the efforts of the subcommittee and of the full committee in our trade remedies legislation. That is just a part of our agenda. We look forward to working with you on the rest of the agenda, and we hope to have that that trade remedies bill on the floor in the next couple of weeks.

Hopefully we can get some action on it.

Mr. RIDGE. I appreciate again, Mr. Chairman, the opportunity. Thank you for your providing it to me.

Chairman GIBBONS. We look forward to working with you. Thank you very much. This will conclude our hearings on this subject. We will keep the record open for about a week in case there are any statements that need to be corrected or added.

I thank everyone for attending and for the suggestions that they have made.

[Whereupon, at 11:05 a.m., the hearing was adjourned.]

[Submissions for the record follow:]

STATEMENT OF HON. FRANK ANNUNZIO, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Mr. Chairman, members of the Subcommittee, the United States is in the midst of unprecedented economic debts. Decisive actions are called for both on our domestic national deficit and our balance of trade with nations.

Recent years have brought balance of trade deficits which would have been unimaginable a decade ago. The deficit in merchandise trade nearly doubled in one year, from 1982 to 1983. Projections for this year place our trade deficit as high as $120 billion, up nearly four-fould from 1982.

The House Banking Committee, on which I sit, has also addressed the issue of trade and American competitiveness in world markets. The recommendations of the Banking Committee should be considered by the House sometime this year, but to consider such recommendations requires a basic change for all of us. That is simply that we must change our ingrained outlook and attitude that American manufacturing superiority is a given, an undeniable truth that cannot be changed. This, quite clearly, is no longer the case.

We have suffered the impact of automobile and electronic inroads into our markets. While American consumers may have benefitted from the low cost of these items and the effect of these lower costs on our inflation, American jobs have been lost forever. Now, we see with alarm those industries in which we have enjoyed undeniable advantages are also at risk, high technology industries, drug industries and the like are all being challenged by foreign competition.

I see the problem as two-pronged. First, the competitiveness of American industry, and second, our national economic climate, namely the skyrocketing national deficit.

I do not believe it is the place of American government to intervene in American industry as is the case with many our trading partners. I do see, however, a place for the government to ease the redtape and problems encountered with development of new products. Innovation, once synonymous with America, has lessened due in part to government actions. While we must protect consumers from harm, we must not at the same time stifle development. We must encourage a strong national manufacturing base through tax advantages and the like. Rewards should be given to those who put people back to work, and industry should reward the productivity of those workers. Research and development should be encouraged and also rewarded. In this way, we may be able to lessen the burden of modernization, innovation, and new product development. At the same time, new, successful products and industries mean more jobs for Americans.

Second is our national deficit. In recent weeks we have taken action to raise revenues and cut deficits, but more should be done. There are still areas in our budget which could and should be reduced. Our defense budget should not be the "sacred cow" which this Administration has created. There is room for revision.

The strength of our dollar due to corresponding high interest rates has an adverse impact on our trade as well. Reducing interest rates and the dollar's strength would go far in also reducing our trade deficit an our national deficit.

We are clearly at a juncture of great importance for the future economic strength of this nation. Reasoned long ranging actions are called for in the areas of competitiveness of industry, national deficit reductions and interest rate moderation. It is my sincere hope that we, as legislators, will be as innovative as American technology is known to be, and take those actions which will maintain and enhance our position world-wide. A strong economy is a must. Actions are a must. Let us do what is necessary.

Congress of the United States,
House of Representatives,
April 24, 1984.

Hon. Sam M. Gibbons,
Chairman, Subcommittee on Trade, Committee on Ways and Means, House of Representatives, Washington, DC.

Dear Mr. Chairman: Thank you for affording me the opportunity to participate in the Subcommittee's hearing on the sources and implications of the U.S. trade deficit by means of this written submission. I would like to focus attention upon the massive textile and apparel trade deficit.

In 1983, the textile and apparel trade deficit was $10.6 billion, fully 15% of the nation's total merchandise trade deficit. The 1984 figures are even more alarming: the textile and apparel trade deficit for January and February was $2.6 billion, a dramatic 67% increase over the corresponding period in 1983. These statistics are cause for considerable concern.

On April 9, 1984, Congressman Ed Jenkins, Chairman of the Congressional Textile Caucus, and I conducted a hearing in Greensboro, North Carolina, to examine the causes of this deficit and to explore proposals for reducing it. We heard insightful testimony from an impressive array of industry leaders. As examples, I am attaching, for inclusion in the record of this Subcommittee's hearings, copies of statements made by the following individuals at the Greensboro hearing:

James H. Martin, Jr., President of the American Textile Manufacturers Institute and Chairman and Chief Executive Officer of Ti-Caro, Inc., Gastonia, North Carolina.

Dewey Trogdon, President of the North Carolina Textile Manufacturers Association and Chairman and Chief Executive Officer of Cone Mills Corp., Greensboro, North Carolina.

Donald R. Hughes, Executive Vice President of Burlington Industries, Inc., Greensboro, North Carolina.

White G. Watkins, Director of Government Affairs of Blue Bell, Inc., Greensboro, North Carolina.

I urge the members of the Subcommittee to study the attached remarks carefully. Four themes recur throughout the testimony which I would like to highlight for the Subcommittee.

First, the interrelated problems of the overvalued dollar and the mammoth federal deficit were universally cited as substantial factors in the growth of the textile and apparel trade deficit. Inflated interest rates resulting from excessive government borrowing not only makes credit for expansion and development more expensive, but also keeps the dollars artificially high by attracting foreign investment. Second, the witnesses expressed substantial frustration in having to compete with government-subsidized foreign competition, while at the same time being faced with insurmountable barriers to exports to many nations. They pointed out that "free trade" is no more than a slogan when our competitors openly refuse to engage in it.

Third, the witnesses made it clear that the foreign threat to the American textile and apparel industries is very real: literally hundreds of thousands of jobs have been lost, many businesses have been closed, and many more are in precarious straits. Finally, the textile and apparel industry spokesman pointed out that the U.S. Government has not been supportive of their international efforts. Their call is for a comprehensive and uniform international trade policy that is less tolerant of barriers raised to American exports and breaches of existing trade agreements.

To that end, ATMI President Martin offered the following program for action to improve the American textile and apparel industries' competitive position in international trade:

(1) Freeze imports at 1983 levels (permitted by GATT and the Trade Act of 1974 to correct imbalances of trade).

(2) Establish global import controls.

(A) Renegotiate bilaterals with the "Big Five" and include aggregate totals at 1983 trade levels.

(B) Renegotiate bilaterals with the following secondary developing countries and include aggregate totals at 1983 trade levels: Pakistan, Republic of the Philippines, Mexico, India, Brazil, Thailand, Singapore, and Indonesia.

(C) Permit import growth at a rate no greater than domestic market growth.

(3) Establish import licensing for all textile and apparel imports from all sources.

I would like to urge, in the strongest way, that the Congress and the President work together to implement these initiatives immediately. I have written President Reagan to inform him of this program and to ask for swift executive action.

Finally, I am convinced that the American consumer is a great untapped resource in the effort to reduce the textile and apparel deficit. The American consumer, when informed fully of the choice between domestic and foreign goods, will more often than not "Buy American." Particularly with respect to textiles and apparel, the problem lies in informing the consumer of the choice. H.R. 4643, which I have cosponsored, will facilitate this choice by improving the labeling of textile fiber and wool products. The bill, which was referred to this Subcommittee on January 27, 1984, will strengthen existing labeling requirements to ensure that imported textile goods bear a conspicuous country of origin label. Existing labeling requirements are inadequate and easily subverted. Further, the bill would require domestically-manufactured textile products to be so labeled.

Let's allow the American consumer to make decisions in the marketplace with full knowledge of the source of the goods being offered. It's fair and it will work. I urge immediate action on H.R. 4643 by the Subcommittee and the Congress.

Again, thank you for giving me the opportunity to share the concerns of these basic American industries with the Subcommittee.

Respectfully submitted,

ROBIN BRITT,
Member of Congress.

Enclosures.

REMARKS BY JAMES H. MARTIN, JR., PRESIDENT, AMERICAN TEXTILE MANUFACTURERS INSTITUTE AND CHAIRMAN AND CHIEF EXECUTIVE OFFICER, TI-CARO, INC., GASTONIA, NC

Congressman Jenkins and Congressman Britt, on behalf of the textile industry, I want to thank you for conducting this meeting today on the textile trade situation.

Practically every company represented in this room this morning has been damaged by the high volume of textile and apparel imports coming into the United States in recent years. In fact, unless we are more effective in dealing with the problems in the next few months than we have been in the past few years, some of us may not be in business much longer.

Last year, 1983, the United States had an all-time high textile and apparel trade deficit, a whopping $10.6 billion. That was 33 percent higher than the previous year. No one thought it could get worse, but it has. During January and February of this year, 1984, the textile and apparel trade deficit was $2.6 billion, up 67 percent from the same time period last year.

The volume of imports into the United States last year represented an estimated 750,000 American jobs in textile and apparel companies. That means that if we had manufactured rather than imported, we would have employed 750,000 more people.

Based on the rate of import growth for January and February, we will possibly lose another 250,000 American jobs by the end of 1984 unless, of course, some significant changes are made in our trade policies and in their enforcement—another 250,000 American jobs exported to other countries.

We've had enough. We've seen enough Americans lose their jobs. We have seen enough American plants closed. It is time that we—you and I, the President, and other Members of Congress—start to think a little more about the economic well-being of our own nation and the people here who need jobs as much as people in other countries.

We in the textile industry had hoped things would improve when the Multi-Fiber Arrangement was renewed in 1981 and the new series of bilaterals negotiated in

1982. But that did not happen. On the contrary, for the first time, imports actually increased at a time when the domestic market was shrinking, during the recession of 1982. Last year, imports increased a significant 25 percent, a rate much greater than the increase in the domestic market.

Obviously, the government's textile program is not working as it should and must be strenghtened. The bilateral agreements covering the imports of textiles and apparel are not broad enough and are not effective. They are established by country and by product category. Yes, there is a procedure for adding new categories, but by the time the government gets around to it, import penetration is too high and the market is already disrupted. This situation, as is obvious from import statistics, is intolerable.

We in the textile industry as well as those in the fiber and apparel industries have been working in every way we know to get effective government action. Some progress has been made. New quotas have been set on 90 product categories. The American Textile Manufacturers Institute and others have filed anti-dumping and countervailing duty actions to attack some of the unfair trade practices and have been successful in cases involving Peru, Japan, and the People's Republic of China. The United States Customs Bureau has been doing a better job of policing imports.

The import problem was addressed in December by Members of Congress and the Administration. It resulted in the President's initiating additional measures to curb import growth. These measures will certainly be of some benefit. But already it is crystal clear that they will not be enough to effectively deal with the overall import problem.

I am now firmly convinced that a new and strong initiative is needed in the Congress, and the Textile Caucus is the place to start. Certainly, we appreciate the efforts under way for legislation to close some of the tariff loopholes and to require country-of-origin labeling, but I strongly believe that Congress needs to act now to freeze imports at the 1983 level. This is permitted by GATT and the Trade Act of 1974 to correct the imbalance of trade. In 1981, the European community effectively rolled back imports from non-EEC countries. That's a matter of record.

Number two: establish global import control, and, under that framework, renegotiate bilaterals with the Big Five, that is, Japan, Taiwan, Korea, People's Republic of China, and Hong Kong, and include an aggregate total at the 1983 trade level. Renegotiate bilaterals with the following secondary developing countries: Pakistan, the Republic of Philippines, Mexico, India, Brazil, Thailand, Singapore, and Indonesia, and include aggregate totals at the 1983 trade levels. Permit growth at no greater than the domestic market growth. And, three, establish import licensing for all textile and apparel imports from all sources.

It was during the Carter Administration that the Textile Caucus was instrumental in sending a strong message to the White House on focusing on textile and apparel imports. It led to the appointment of Robert Strauss as trade representative, and he provided a strong voice for American textile and apparel industries in international forums. It is time for such a message again to be sent to the White House. We need tighter and broader bilateral agreements and more prompt response to abuse and barriers.

And, I would go a step further. I would think it may well be time for the Congress to re-examine the Multi-Fiber Arrangement and perhaps our entire international trade policy. Something is grossly wrong when the United States runs an international trade deficit of $69.4 billion, as it did in 1983, and that figure is expected to reach $100 billion or more in 1984. For February alone, that deficit reached $10.1 billion, the record for a single month. Obviously, the problem is not limited to textiles and apparel.

I think that our trade deficit is as much a problem as the budget deficit, for it translates directly into lost jobs—American jobs. If this country is to remain strong economically, if it is to remain a leader in the world, we must continue to grow and to prosper and to build, and we cannot do that if we have a million textile and apparel people out of work and seeking relief, and if we have plants close down, unable to use suppliers and services of other Americans and unable to pay their bills.

Let me conclude, gentlemen, by saying this. We in this industry and the apparel industry and the fiber industries have done our very best. We have worked hard, and we have invested heavily in the latest technology. We are today the most efficient, the most productive, the most modern industry of our type in the world. We pay the highest wages, probably the highest taxes, and produce the best quality products, but we and a few other American industries cannot remain strong unless our government is willing to support us and encourage us and guarantee balanced and fair trade policies.

We sincerely seek your help in a partnership with private industry to help keep our industry strong and viable and our country prosperous and powerful.

Thank you very much.

Remarks by Dewey Trogdon, Greensboro, NC

Congressman Jenkins, we are pleased to have you in North Carolina; and Congressman Britt, we appreciate your scheduling this meeting. And, I thank both of you for your interest in and support of the textile and apparel industry. Unfortunately, our problems with imports continue to grow and have created for us an alarming situation.

The flood of imports is affecting companies in many states, but perhaps nowhere is the economic impact as great as here in North Carolina. About one-fourth of the nation's textile industry is based in North Carolina as is a sizable portion of the apparel industry. There are few companies here that have not been hurt to some degree by imports.

Textile employment in North Carolina is about 228,000 at the present time. That's down from about 250,000 jobs just two years ago. Some of those lost jobs are due to increases in productivity, but most were lost to imports. In fact, without the dramatic increases in imports in the last several years, I expect we would have seen increases in textile jobs in North Carolina in response to the recent general upturn in the nation's economy.

Like many other companies, Cone Mills has been adversely affected by the international trade situation. We have seen a significant decline in our export business, in part because of the high value of the dollar, but also because of practices of the governments of some of the countries into which we had exported. At the same time, we have seen imports grow in our product areas, in some cases apparently subsidized by foreign governments.

I expect all of us in the textile industry have asked ourselves whether our industry can compete in world markets. Certainly, our wages are much higher. The cost of complying with government regulations is much greater. And, our industry is more competitive within itself. Those things, however, are offset by the investments we have made in modern efficient equipment, by the fine and dedicated people throughout our operations, and by the overall good quality of our products.

Our major disadvantage is the basic attitudes of some of our government officials in Washington.

There still is an almost devotion to the "free trade" philosophy which in reality doesn't exist today. Our competitors certainly aren't free traders. By and large they shelter their domestic industries, importing only what they need and not allowing outside competition. And, in dealing with our open door policy, they often resort to export subsidies, targeting, manipulated currency values, etc., to gain market share.

Apparently our government has no uniform trade policy. Departments and agencies often seem to go their separate ways. We are too tolerant of barriers raised to stop American products from entering a foreign country and to abuses by foreign competitors of their trade agreements with the United States. Unless we have a believable threat of retaliation to barriers and market disruptions, some of our competitors are going to continue to take advantage of us.

There also is a "Megatrend" attitude among some in Washington. It is almost as if some see the exporting of our manufacturing industrial base and relying on the service sector and selected "high tech" industries as predestined. But, if textiles and shoes and steel and cars and appliances and other manufacturing industries fail in the United States, then who is going to use those services and all that "high tech"? Certainly not foreign governments, if they can do the same things cheaper and with their own people.

What I would like to see is a change in some of these attitudes. I would like to see this nation have an industrial policy that would encourage investment, research and development, technical education, and exporting. The budget deficit would be a good place to start. A balanced budget would certainly reduce interest rates and encourage the private sector to build and develop. And, if government is really there to help, some incentives for investment, for research and for exporting should be enacted into law.

The United States needs a strong pro-trade policy, one which would not trade off our long-term economic stability for short-term political gain. Government with all of its secretaries and departments and agencies should work, not at cross purposes, but together to promote American product sales internationally. I favor the proposal for a new Department of International Trade and Industry, but only if it is close enough to the President to guarantee the coordination of its policies with other agencies working in the international area.

In the short term, the textile industry needs your support, indeed it needs your leadership to tighten up the system now in place. The seriousness of the import problem should be constantly before the administration and the Congress until improvements are evident. Legislation before the Congress to require the display of country-of-orgin labels in textile and apparel products needs approval by this session of Congress.

And, this Congress should examine closely the present international trade policies which have permitted the exporting of so many jobs and so much of American industry. The multilateral trading system for textiles and apparel needs to be examined and probably restructured. There is no question in my mind but that our government needs to control its own economic destiny. If that is to be done in the textile and apparel areas there must be a system created to establish global quotas and to control importing through a licensing system.

Certainly, we appreciate your coming here today to hear our views on the problem of textile and apparel imports. It is a crisis situation which demands immediate attention by the Congress. We respectfully urge that the House Textile Caucus take the initiative now to impress upon the administration the seriousness of the situation and to formulate appropriate legislation to provide a fair international trade policy for textiles, apparel and other American industries.

REMARKS BY DONALD R. HUGHES, EXECUTIVE VICE PRESIDENT, BURLINGTON INDUSTRIES

Representative Britt, Representative Jenkins, I would like to thank you for giving me this opportunity to speak to you this morning.

My remarks will differ somewhat from the others you have heard so far today. I will broaden the scope to include all U.S. manufacturing, not just textiles and apparel. I will emphasize the need for a strong manufacturing sector to insure the continued economic prosperity of the United States.

MANUFACTURING BACKGROUND

Since the industrial revolution, beginning just before the Civil War, manufacturing has been the driving force behind U.S. economic growth. The textile industry was a leader in the beginning, using machinery and the factory concept to produce goods that were previously "homespun". These early mills provided an increased supply of goods at prices which could not be imagined without mass production. The mills also provided jobs for workers who were not content to remain on the family farm or who had been displaced by productivity advances in agriculture.

As manufacturing prospered, America prospered, with GNP reaching 40% of world output. Over the first half of this century, manufacturing output grew faster than the economy as a whole, steadily gaining share of total GNP. Because manufacturing productivity grew at a faster than average rate, it made a large and positive contribution to the increase in the nation's standard of living.

This rapid growth continued up until 1966, but then the trend changed. The margin of manufacturing growth over general growth disappeared. Non-manufacturing employment, chiefly services, grew much faster than manufacturing employment, changing the composition of the workforce. Because productivity growth in services is slower than in manufacturing, this larger role for services translated into slower productivity growth and slower growth in the standard of living. Without these healthy increases in productivity, inflation became a more prominent problem. Imports grew at large annual rates of increase.

Today it is clear that manufacturing, the strong base of America's growth for over a century, is under attack:

> Manufacturing's share of employment has fallen by a third since 1950 (34% average 1948–52, 22.5% average for 1978–82.)
>
> Production growth has slowed, from 5.8% growth per year in 1958–62 and 7.2% in 1963–67 to 2.8% in 1968–72, 1.6% in 1973–77 and a −1.6% rate in 1978–82.
>
> On the other hand, the import penetration rate for manufactured goods grew from just over 4% in 1966 to nearly 14% of all manufactured goods in 1980.
>
> U.S. exports grew from 5% of total manufacturing shipments to over 10% during the same time period, however, this growth was not rapid enough to keep pace with the explosion in world trade.
>
> The U.S. share of manufacturing exports fell from 22% in 1965 to 15% in 1980.

In contrast, Japan increased share of manufacturing exports, and managed to maintain that share even in the face of an increased role for oil in world markets.

REASONS FOR THE DECLINE

1. Lack of investment

Although the overall rate of manufacturing investment remained relatively constant in the U.S., the mix changed:

Traditional industries accounted for over 72 percent of investment in 1958-62, This share declined steadily to a 66 percent share in 1978-81. The smaller "high-tech" sector was growing while the traditional industries were not investing enough to maintain their position. Defense-related businesses also benefitted.

Tax laws were a key factor in diverting investment money away from the manufacturing sector. Tax shelters subsidized the building of stores, apartment, warehouses and offices. Leverage could be employed to a greater degree in real estate while manufacturing struggle to maintain "strong" (low debt) balance sheets.

Real manufacturing investment in the U.S. averaged 3.9 percent from 1965 to 1982. In Japan, the rate was often twice that in the U.S., running at 7 percent or more from 1968 to 1974 and not falling below 5 percent during the 18-year period. This sustained period of high investment enabled Japan to build a manufacturing base that was the most modern in the world in many key areas.

2. High cost of capital

A key ingredient in the U.S. manufacturing industry's loss of competitive position is its relatively high cost of capital. Manufacturing's cost of capital is high relative both to other businesses domestically and to foreign manufacturers. In Japan, manufacturers are able to use higher levels of debt due to the close working relationships between government, banks and manufacturers. Studies have indicated that in periods of double-digit inflation, debt capital actually enjoys a negative marginal tax rate while capital raised through new stock issues can face a marginal tax rate that exceeds 100 percent.

Another very basic reason that the cost of capital in the U.S. is higher is that real interest rates are higher. The Japanese Government, recognizing the benefits of cheap capital to industry, administers economic policy to keep interest rates low. On the other hand, U.S. financial markets have been attracting capital from all over the world because of the high real interest rates available. These are the rates that manufacturers must pay when they need external funds for expansion and modernization.

As a result of these factors and others, manufacturing in the U.S. has been forced to pay a much higher price for capital than manufacturers in the other industrialized countries. A recent study shows that over the past 20 years, the cost of capital in the U.S. has been at least twice that in Japan. In 1980, the cost in the U.S. was 20.8 percent nearly three times the 7.8 percent cost in Japan.

3. Strong dollar

Perhaps the most fundamental cause of our loss of competitive position was the over-valuation of the dollar in foreign exchange markets over the past 34 years.

A Data Resources Inc. study analyzed the effects of the extraordinarily stong dollar over the past three years. If the dollar had remained stable at its summer 1980 level, the benefits by 1983 would have been:

Real GNP 2.3 percent higher.

Industrial production 5.3 percent higher.

Total employment would have been one million higher, with 800,000 of those jobs coming in the manufacturing sector.

4. Tax and regulatory policies

U.S. tax laws have not allowed depreciation rates sufficient to keep pace with the consumption of capital. As inflation worsened, the practice of writing down historical costs fell even farther behind the real needs of industry. Liberalizations of depreciation allowances in 1954, 1962 and 1971 were insufficient. The Accelerated Cost Recovery System included in the Economic Recovery Act of 1981 brought average depreciation allowances closer to an economic level, but disparities still exist between industries.

Environmental policies required major investments in pollution control equipment. The cost to industry has been high:

From 1973 through 1982, manufacturing devoted 6.2 percent ot their investment to pollution control equipment.

However, the cost was not evenly distributed.

Primary metals spent an average of 14.9 percent of their investment capital on pollution control, with expenditures exceeding 20 percent in the highest year.

Chemicals spent an average of 9.1 percent over the same period.

5. Damaging credit cycles

The slowdown in manufacturing growth has been exacerbated by increasingly severe business cycles. Seven recessions have occured since 1950, all impacted unfavorably on industrial production, profitability and capital formation:

Production declined by an average 12 percent.

Profits declined an average 37 percent.

These cycles limited the ability of manufacturing industry to use debt and forced the substitution of more costly equity capital. These swings in profitability also hampered the use of internally generated funds for investment. Had the economy followed a more stable path:

Investment would have been higher by an average 10.6 percent per year.

The manufacturing capital stock in 1980 would have been 8.4 percent larger.

This could have been a significant factor in industrial competitiveness.

6. Technological shortfall

The educational system did not keep pace with the need for engineers:

In 1980 the U.S. graduated 69,000 Bachelor level engineers. Japan, with a population half that of the U.S., graduated 73,000.

The U.S. has historically been a leader in R & D expenditures as a percent of GNP. However, if defense and space are subtracted, we fall below both Germany and Japan.

The U.S. textile machinery industry is an example of this failing: Thirty years ago, the U.S. was the world leader, now the domestic industry has all but disappeared.

NEED FOR ACTION

The recent recession was only a sampling of what is to come if the U.S. continues to allow its manufacturing industry to fall behind other industrialized nations. More of the high paying manufacturing jobs will move to foreign countries which have built their national strategies around a strong manufacturing sector. Without manufacturing to lead the growth in productivity, economic growth will slow and the ever-increasing standard of living that Americans have come to expect as a birthright will become a thing of the past.

The causes of these problems of industry are becoming more widely understood, however, many economists and public officials feel that market forces will ultimately solve them.

The danger is that the market will not react fast enough to counteract the concentrated efforts of Japan and other industrialized nations which make growth in manufacturing a matter of national strategy. Action must be initiated now. Long term trends cannot be reversed overnight. By the end of the decade these problems will be so firmly entrenched that they may well be insoluable.

These major items must be addressed now:

The dollar must be brought to a more realistic value through vigorous reductions of the Federal budget deficit.

Interest rates must also be reduced to lower the cost of capital.

Monetary and fiscal policy must be designed to promote a more stable and sustainable pattern of growth in the economy.

The U.S. should place greater emphasis on economic goals in its conduct of foreign policy.

International trade policies should aim to reverse the declining role of U.S. manufacturing in world trade.

New procedures must be developed to assure that the industrial viewpoint is taken into account in all major policy decisions.

Regulatory and tax policies should be formulated with due consideration to the impact on manufacturing industry.

STATEMENT OF WHITE WATKINS FOR BLUE BELL, INC., GREENSBORO, NC

Mr. Chairman, Congressman Britt, Ladies and Gentleman, I am White Watkins, the Director of Governmental Affairs for Blue Bell, Inc., the second largest apparel company in the United States. Blue Bell is headquartered here in Greensboro. We manufacture sportswear, westernwear, bathing apparel and garments for the industrial laundry trade. Our primary brands are Wrangler, Maverick, Sedgefield, Jantzen and Red Kap.

Mr. Chairman, we appreciate your interest in the problems and opportunities facing the textile and apparel industry. Further, we appreciate the fact that you as Chairman of the Textile Caucus are affording us the opportunity of testifying before your Committee.

I am sure many of you have just seen the latest import figures published. Textile and apparel imports for February 1984 reached the highest monthly level in history, exceeding the previous record by almost 100 million square yard equivalents (SYE). This February's all-time high of 882.6 million SYE surpasses the previous record of 798.8 million SYE in January. The two months also are the highest year-to-date period of textile and apparel imports in history, recording 1.68 billion square yard equivalents, up 45 percent over the first two months of 1983. Textile imports were up 66.5 percent, apparel imports showed an increase of 28 percent and yarn import increased 91 percent during the first two months of 1984 compared with the same period last year.

During 1982 there were over 2 million employees in the textile and apparel industries in the United States. We, at Blue Bell, employ 23,500 of these fine people in the United States. The jobs of these individuals depend on the reduction of imported textile and apparel goods into the United States. We cannot allow ourselves to become a service oriented nation without a viable manufacturing base.

Let's look at it from a broader range. Unemployment is of great concern to all of us. Statistics show that this past Christmas if every American shopper had purchased the same amount of apparel items but had purchased just $20.00 more American-made clothing of their total rather than imports, it would have created 100,000 new textile and apparel jobs. You probably think the answer to our present problem is quite simple—convince Americans to buy American-made apparel.

This is easier said than done. However, Blue Bell, along with several other companies represented here, have joined in a nationwide "Crafted with Pride in U.S.A." campaign to encourage Americans to buy American. But,—we can't do it alone. The American apparel industry can compete with the imported garments on quality, design, delivery, etc. But, we cannot compete when it comes to cost. Consider the wage scale in the U.S. compared to the wage scales of Hong Kong, Taiwan, Peoples Republic of China, etc. With many of these countries we are competing with a non-economic based economy.

280,000 jobs have been lost due to imports in the apparel industry over the last ten years. The total impact of these lost jobs on the entire U.S. economy is devastating. Imports affect our nation not only by loss of jobs which means lost purchasing power, lost tax revenue, lost dignity on the part of the American worker. But, our nation as a whole loses also due to an increase in government expenditures. We lose on the one hand with lost tax revenues but equally as important we lose on the other hand by increased unemployment benefits and various other types of entitlement program outlays.

Using these 280,000 lost jobs as a base, it is staggering how many other jobs have been lost because of what is called the "Domino Effect". What about the loss of jobs in companies that make buttons, zippers, thread, lining—on down to the trucking industry that carries the apparel garments to the consumers.

Now, let's look at it from the other end. A number of years, ago, the U.S. Chamber analyzed the "Domino Effect" of new jobs in an average community. This study stated that 100 new jobs provide:

(1) An increase of $1,000,000 in personal yearly income;
(2) One more retail establishment;
(3) An increase in retail sales of almost $500,000;
(4) The creation of 68 new non-manufacturing jobs;
(5) An increase in bank deposits of almost $500,000;
(6) A population increase of 351; and
(7) An increased school enrollment of 79.

And, the dollar figures can be multiplied by a factor of two to three times since this study was done 10 to 15 years ago.

The American textile and apparel industries are in a position where something must be done to help us stay alive. We, at Blue Bell, are modernizing our plants and operations to be better able to compete with foreign imports and we are totally committed to the "Crafted with Pride" campaign to alert the consumers to American-made goods.

But again, we can't do it alone. We believe that the announcement in December by the Administration is a step forward in dealing with the problem of disruption of the American textile and apparel markets by imports. Further, we think that it is evidence of the President's prior stated commitment to the preservation of U.S. jobs in the textile and apparel industries. As is almost always the case, the effectiveness of this policy statement will depend upon the dedication and attention on the part of the Administration as to its implementation. If this written policy is followed up with concrete action, then it is definitely a step in the right direction. If this written policy is slowly pushed aside as has been in the case in the past, then we are going to continue to see the U.S. textile and apparel industries dwindle even further. It is very important to keep in mind that this trade policy only triggers a "hard look" at categories in which import increases are occuring. The policy does not provide for automatic limits by categories which are so badly needed for the benefit of the American consumer, the American worker, and our industries.

This whole subject of imports needs to be addressed with the establishment of a long-term international trade agreement which includes at least the following:

(A) Revision or elimination of the existing MFA's market disruption provisions to permit a multi-country (global quota) approach to import restraints. A clear starting base must be established with the specific plan to get to the multi-country approach.

(B) Overall ceilings on imports in all sensitive categories from all developing country suppliers. A clear definition of sensitive categories must be established from the outset.

(C) Aggregate limits by categories on apparel imported from Hong Kong, Taiwan, Korea, and China.

(D) Limits provided in (A) and (B) would be based on some historic period—latest twelve months, average of several preceding years, etc.

(E) Aggregate levels of categories for Hong Kong, Taiwan, Korea, and China could grow no more than the U.S. market. If the U.S. market does not grow or decreases then aggregate levels of categories for Hong Kong, Taiwan, Korea, and China would be reduced accordingly.

(F) Growth rates for other developing countries could be set at a somewhat higher level, but would be based on the volume of exports by categories from the particular country. The larger the total exports, the lower the growth rate. A trigger mechanism will be included to alert the Commerce Department. This trigger will also halt all shipment of that category while the investigation is going on.

(G) Provision would be made for new starters including the trigger.

(H) Imports would be controlled by the United States through a licensing system. Import licenses would be issued to importers within the quotas set for a product and country, and would not be transferable. This type of licensing system would preserve the existing bi-lateral structure.

(I) Apparently, our data processing system at ports of entry needs to be brought into the 20th century because there obviously is no central data system (computer) with terminals at each port of entry into the U.S. in order that the customs agents can punch in a country and a category and determine the current status of their import situation by category. Such a system should be implemented immediately. There is also a delay in reporting what is coming in from different countries as these goods go into holding warehouses. A system should be implemented immediately for all goods destined for entry into the U.S.A. whereby these goods should be inspected and an immediate determination made as to whether they are properly categorized and whether or not this shipment will exceed the quantity left on a country's quota in that particular category. At the same time the information punched in by the receiving port should be up-dated thus showing quantity left for that category/country. If goods are destined for transshipment to another country through a U.S. port, there should be very tight control on these goods while they are in the holding warehouses and our government should make certain that there is a fool-proof system of in/out paperwork for all of these transshipments. If for some administrative/manpower/technical reason it is impossible to completely audit all goods destined for U.S. customers, at the time they are off-loaded from the ship there should be a two to four week delay in the release of these goods in order that a thorough audit can be accomplished. A very specific maximum time period should be established for all goods to be held in holding warehouses for entry into the U.S. in order to put a stop to stock piling and thus allowing for market disruption by flooding the market at any given time such as back to school/Christmas periods. Our government through bi-lateral agreements with the exporting nations should establish U.S. observers on the exporting end to thoroughly audit shipments from that country by category/quota and to keep a continuous eye on transshipments.

(J) If documentation for a particular shipment is incorrect as to content or category or if the amount of the shipment exceeds that country's quota for that category by some obviously unreasonable figure, the entire shipment should be confiscated or a very severe penalty (two to three times the value of the goods) should be imposed.

Further, if it can be proven that a country with which we have a bi-lateral agreement is involved in any way in allowing transshipments through their country their quota should be cancelled for five years. All carryforwards, carryovers and category swings should be stopped immediately. If the country did not use their quota during a given period of time, there should be no exception as to allowing them to use the remaining quota in any other way—the remainder should be cancelled.

In summary, Mr. Chairman, the textile and apparel industries are not asking that our government build an import shield around our industries. Rather, we are asking that as a first step, the present bi-lateral agreements be stringently enforced by the departments of government responsible for their enforcement. That we arrive at some sort of equitable trade apportionment with the remainder of the world. In essence, saying to the remainder of the world—"You may have X percentage of our market but you are not going to take it all". We want only fair treatment. Every industrialized power on earth must be able to feed, clothe, and house itself. We must retain that ability and not allow our textile and apparel industries to be lost in the process, at which point we ould be at the mercy of other countries. The textile and apparel industries are basic industries to our nation. We, as a nation cannot—indeed we must not—lose any more of these two vital industries.

Thank you for the opportunity of presenting our views today.

Statement of Hon. W.G. "Bill" Hefner, a Representative in Congress From the State of North Carolina

Mr. Chairman, I appreciate this opportunity to submit testimony for the record on behalf of the trade deficit, and I would like to discuss the very important issue of textiles.

The district that I represent in North Carolina has been affected by the trade deficit in the textile and apparel industry. In 1983 the textile/apparel trade deficit was $10.6 billion, which is about 15% of the nation's total trade deficit of $69.4 billion. This is a very high percentage for a single industry, and the situation demands attention by the President and Congress.

The position the President took in December to issue calls on import categories where market disruptions occur was too late for 1983, and the new measures do not effectively deal with the overall import problem. These measures will do little to prevent market disruption, to prevent shifting to non-controlled categories, to prevent shipping through other countries, or perhaps most importantly, to reduce barriers to our textile products.

There is a perception that the textile/apparel industry already has in place sufficient protectionist measures to shield it from imports. In actuality, the textile/apparel industry is not sufficiently protected.

The American Textile Manufacturers Institute recently put forth the following proposals for the control of imports. I urge the Committee to carefully consider these recommendations during its delibertions on the appropriate course of action required to reduce the trade deficit:

Freeze imports at 1983 levels.

Establish global import controls through a renegotiation of our bilateral agreements with, Japan, Taiwan, Korea, Hong Kong, and China; and with lesser developing nations like, Pakistan, Mexico, India, Brazil, Thailand, Singapore, and Indonesia.

Establish import licensing for all textile and apparel imports from all source.

I am also in support of H.R. 4643 introduced by Rep. James Broyhill (D,N.C.). This legislation would improve the labeling of textile fiber and wool products. The primary purpose of H.R. 4643 is to strengthen our domestic laws as they relate to the country of origin labeling requirements for textile products.

I also support H.R. 4590 introduced by Rep. Butler Derrick (D,S.C.). H.R. 4590 would statutorily authorize the Committee for the Implementation of Textile Agreements to provide a trigger mechanism so that negotiations could be entered expediently whenever imports reached a certain level of penetration. The bill also has a provision that would prevent carry over of unused quotas.

In addition to trade agreements, the President must do something about the federal budget deficit. Martin Feldstein, Chairman of the Council of Economic Advisers, testified before the House Budget Committee in February that the trade deficit was a result of the enormous federal budget deficit.

As much as half of the trade deficit may be caused by the over-valued American dollar, which is a direct result of the budget deficit and the upward pressure it puts on interests rates. When the dollar is compared with other currencies it raises the relative price of American exports, and lowers the price of imports. If the budget is brought into balance, so will the dollar, and so will much of the trade deficit.

The House has adopted a First Budget Resolution for FY85 which achieves a deficit reduction of $182.3 billion over three years, compared with $149 billion achieved under the Reagan Republican Plan. We need to continue to pursue a course to eliminate the deficit and balance the budget.

That impact of the current flood of textile imports makes it imperative that Congress and the Administration take a long hard look at various remedies to enable our domestic textile industry to compete effectively. I am concerned that if the President will not take effective action, Congress might be forced to act in a manner that is more restrictive than is desirable or prudent for our interests in international trade. It is not a question of free trade, because free trade does not exist in the real world. The issue is fair trade. Our trade agreements must be re-examined, and we must find a way to reduce the enormous federal deficit. If we surrender the position of the American textile industry through a policy of neglect, we will find it difficult to revitalize the industry in the years to come.

STATEMENT OF HON. RICHARD L. OTTINGER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. Chairman and members of the subcommittee, I would like to congratulate you for your foresight in holding these hearings. The Nation's trade deficit, a threat to our industries and our jobs, is one of many warning signs that the President's economic recovery is weak and unstable. Since 1980 it has contributed to an increase in unemployment by two million jobs and has caused the GNP to fall by 2%. I hope that these hearings will be successful in helping us reach a consensus regarding the direction Congress must take to help alleviate the pressures this deficit is placing on both our economy and that of the world.

The trade deficit we face today has ballooned from an $8.9 billion surplus in 1975, to a deficit of $28 billion in 1981 and a $69 billion deficit in 1983. Some economists predict it could almost double to an unprecedented $120 billion by the end of this year. if it is not reversed it will bring inevitable collapse to our tenuous economic recovery. As a product of increasing budget deficits, high interest rates and an overvalued dollar, the trade deficit is weakening the export and manufacturing sectors of our economy. In 1983 exports were off by $37.5 billion from 1981, bringing a loss of 1.3 million American jobs. As this deficit increases a greater number of jobs will move overseas.

While today's deficit is the product of many complex factors, steered by both internal and external forces, there is no doubt that its origin can be attributed to President Reagan's economic policies passed by Congress in 1981. I vehemently opposed his policies from the beginning realizing the destablizing effects they would have on the economy. The administration's endorsement of Federal Reserve Board Chairman Paul Volcker's tight monetary policy, combined with an absurd fiscal policy, policy forced interest rates to skyrocket and brought with it a deep worldwide economic recession. The President's economic package which slashed taxes by $135 billion a year while at the same time pouring billions of dollars into a wasteful Pentagon was, as Vice President Bush described it, truely "voodoo economics." Even with debilitating cuts in vital public programs such as job training, education and economic development, the decimated Federal Treasury produced $200 billion Federal deficits which, according to Budget Director David Stockman will continue "as far as the eye can see."

Federal deficits and tight money have produced and supported interest rates at historically high levels as private and public borrowers compete for scarce capital. These persistently high interest rates are contributing to the trade deficit in two significant ways: creating an overvalued dollar and increasing the debts held by the developing nations.

The high dollar has priced our exports out of competition in the international market. Its value with respect to the currencies of our trading partners is severely harming our industries' ability to compete with foreign products—turning our once affordable exports into luxury goods. The high cost of the dollar is also increasing the desirability for American consumers to purchase imports which cost less than American-made products. Many American manufacturers are responding to declining sales by pulling out of the U.S. and moving jobs and production overseas.

The interest rates are also contributing to the mounting debts facing the third world countries. As the servicing of their debts increase, the financial resources these nations need to rebuild their economies is becoming desperately scarce. This directly affects the amount of imports they can afford to purchase from the U.S. For example, between 1981 and 1983 our trade picture with twenty Latin American republics, including Argentina, Mexico and Brazil, switched from a $5.4 billion surplus to a $14.7 billion deficit. The increase of our total world trade deficit increased by $26.7 billion dollars between 1982 and 1983—$11 billion dollars of that gap is due to reduced trade with Latin America. This reduciton in trade with Latin America alone has caused the loss of 250,000 American jobs according to the Federal Reserve Bank of New York.

The overvalued dollar and high interest rates are also damaging to economies of our other major trading partners. Many of the western European nations point to the cost of the dollar as one of the greatest barriers to their economic recovery—a recovery our economy depends on to remain healthy. As the dollar increases so does the price other nations must pay for oil and petrochemical products, which are sold in dollars. For instance, West Germany pays 3.5 percent more in Deutsche marks for a barrel of oil than it did three months ago, even though the spot market price for oil has dropped three percent over the same period. High interest rates are also stalling an international economic recovery as our trading partners bolster their rates in an attempt to ward off inflation. These higher rates mean that fewer industries are able to afford the capital investment needed to rebuild their facilities, create jobs and begin reducing the double digit unemployment plaguing their economies.

These high interest rates and the overvalued dollar are directly linked to the $200 billion Federal budget deficits. The budget deficits will only be reduced when the policy which created them, Reaganomics, is reversed. As an alternative to President Reagan's policies we must establish an economic plan which will direct money back into the economy through industrial renovation and job creation. The economy will improve as deficits fall, forcing both interest rates and the dollar to drop to a realistic level. I have developed such a policy with 75 Members of the House, the national economic recovery project, which was endorsed by 153 members—a clear majority of the Democrats in the House.

This project seeks to address the inherent problems in our economy, including the budget and trade deficits, double digit interest rates and high unemployment, produced by President Reagan's misdirected economic program. To ensure a lasting recovery we call for a policy which returns equity to the tax program by ensuring that every person and corporation pay their fair share; reduces the Pentagon budget to a level which will promote our national security without breaking the bank; increases spending to programs designed to create jobs and improve industrial production; and directs the Federal Reserve Board to finance a high production economy and ease pressures on interest rates.

Not only will this plan increase employment and productivity but it will also reduce the Federal deficits. In a series of preliminary economic scenarios prepared for the group by Dr. Nancy Barrett, formerly of CBO and now chairwoman of the economics department at American University, we were are to show that, under various scenarios, the budget deficits would fall to a level below that of former President Carter's last year in office.

STATEMENT OF HON. LYLE WILLIAMS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Mr. Chairman, I thank you for the opportunity to address the issues of concern that have prompted your hearings in front of the Subcommittee on Trade of the Committee on Ways and Means—the sources and implications of the U.S. trade deficit—and to provide my input as to what particular sectors I believe have been most affected by increased imports.

The situation with regard to imports has had a no more serious impact anywhere than on the district I call home and represent in Congress, the Mahoning Valley of Ohio—the steel valley—Youngstown and several surrounding smaller communities that once were strong with the success of steel. Several mills in the Youngstown area—with names etched in the history of the industry: Youngstown Sheet & Tube's Campbell Works and Brier Hill Works, and U.S. Steel's Ohio Works—have been closed altogether. Now all those once proud behemoths representative of the former might of this country's steel industry produce—are echoes.

In the last five years, 170 steel-producing facilities have been closed in the United States. The American Iron & Steel Institute pegs this country's steel industry losses in the last two years at approximately six billion dollars. Certainly it would be inaccurate to say that all the problems of steel in the United States have been caused by imports. But a reasonable argument can be made that the industry has been severely damaged by import penetration into the market. In January of this year, according to the American Iron & Steel Institute, imports as a percent of apparent supply (which is shipments plus imports minus exports) were at 26.1, up from 19.7 percent in January of the year before. Imports rose from 1,097,621 tons to 2,081,095 tons. According to the congressional steel caucus, the rate of import penetration into the United States since 1950 has gone from 2.3 percent to 22.3 percent and is projected to continue its upward climb.

The cost of producing steel in many foreign countries is subsidized by the governments of those countries. On April 18th, the Commerce Department made a final determination in three cases where preliminary indications showed benefits were derived from government subsidies. The Department has found evidence that three Brazilian firms producing carbon steel received such benefits. The firms are CSN (Companhia Siderurgica Nacional), with a subsidy of 62.18 percent, Cosipa (Companhia Siderurgica Paulista) with a subsidy of 36.48 percent, and Usiminas (Usinas Siderurgica De Minas Gerais S.A.) with a subsidy of 17.49 percent.

Worse yet, there is evidence that foreign steel is being dumped in this country, the largest steel market in the world, at prices below the cost of production and transport. For instance, earlier this year the Department of Commerce ruled that imports of hot-rolled carbon steel plate from Brazil were being sold in the United States at less than fair value.

The rules are different for players in the same game. And our players, the Nation's steel companies and the thousands of steelworkers who have devoted their lives and have received their and their families' livelihood from the industry as did their fathers before them, are suffering because of the inequities.

How do they compete? The answer is: with great difficulty. Subsidization and dumping put this Nation's steel industry at a distinct competitive disadvantage, unfairly reduce the potential market, and thus reduce revenue—revenue that could be used for modernization and technological innovation to make our aging steel facilities more competitive in the world marketplace. Removing that competitive disadvantage also would, in turn, make it more attractive for this Nation's steel companies to reinvest in their facilities, where there would be a greater chance for a return for effort and dollars invested. As it now stands, of the 40 industries surveyed by the Department of Commerce for rates of return on investment, steel is rated at the bottom.

Following on the footsteps of the economic impact of imports on the companies is the impact on the steelworkers and on the regions and communities in which those workers live, such as Youngstown, Warren, Niles, Campbell, and Struthers, Ohio in my home distirct. Lack of reinvestment in facilities due to unprofitability—in part caused by imports—results in a lack of reinvestment in the community. Steelworkers are out of work in staggering proportions. In the last five years, 200-thousand jobs have been permanently lost in this country's steel industry. In my home district the sight of those massive facilities with smokestacks now having no purpose other than to serve as smokeless reminders of the problems faced by this country's steel industry, the severely curtailed city services due to the erosion of the tax base, the steelworkers who have been cast out of their traditional occupation and thus from their traditional way of life, and the resulting pressure palced on Federal, State and local social service delivery systems—both governmental and otherwise—are a strong statement of the ills of the steel industry in the United States, Ills brought on, in large parts, by unfair trade practices.

As a remedy to the foreign import problem being faced by this country's steel industry, I believe a couple of different actions could be taken.

First, the type of quotas that would be tied to modernization requirements placed upon this Nation's steel industry, as contained in a bill of which I am a co-sponsor, H.R. 5081 ("the Fair Trade in Steel Act of 1984"), would provide for and encourage reinvestment in and modernization of our aging steel facilities at appropriate levels in return for the establishment of import quotas. These quotas would help in removing that competitive disadvantage created by subsidized and below-cost imported steel and thus would help in stimulating investment and modernization. Although there are those who believe that administrative remedies provided for in current trade laws are adequate, the record (as statistics I have cited in this statement indicate) speaks for itself. This is not to say that administrative efforts could not be successful.

A second action in that regard I believe could help remedy the foreign import problem and this Nation's trade imbalance—not only in steel but in the overall trade picture—is creation of the proposed Department of International Trade and Industry. The Department would not be a substitute for a coherent, fair and aggressive trade policy but rather would be a necessary precondition to establishing that policy. Current trade policy is not developed and implemented in any one place. The players include: the Departments of Commerce, State, Defense, and Agriculture, along with the U.S. Trade Representative, the International Trade Commission, the Export-Import Bank, and the Overseas Private Investment Corporation. The result is that U.S. trade policy is not really developed in the national interest but rather is brokered among the various players. Our trading partners and domestic special interests easily can play off one agency or department against the others. This current system of many players does not allow for accountability. If the problems we now face in the area of trade are to be solved, then the United States Government should speak with one voice regarding trade, and those who are charged with the responsibility for representing the United States in trade matters must be accountable to the Congress and the people. The creation of the Department of International Trade and Industry would either eliminate or, at least, minimize the current chaos. I believe that the creation of the Department of International Trade and Industry can assist in the promotion of American exports and thus retain and create more American jobs.

Mr. Chairman, we all believe in free trade. But the United States needs not only free trade, but fair trade as well.

STATEMENT OF AMERICAN IRON & STEEL INSTITUTE

World trade is now a pervasive fact of life for U.S. business, and the benefits it has brought have been one of the underlying causes of post-war prosperity. While the dislocations caused by international competition since 1950 have been sometimes painful, these are certainly outweighed by the strong arguments for further expanding trade based upon real comparative advantage.

Unfortunately, government policies affecting the international competitiveness of U.S. manufacturers appear to be inadequate. Strengthening the U.S. manufacturing base does not appear to be a top priority in terms of the national interest—in sharp contrast to the priorities of some countries which have economically out-performed the U.S. over the past decade. It is widely recognized that continuing high interest rates have a devastating effect on capital investment and thus on industries like steel, whose sales are linked to the amount of investment in the economy. Yet, the negative impact of these interest rates on international competitiveness has received little attention. High U.S. interest rates make it attractive to invest in dollars, boosting the value of the dollar and thus reducing the dollar denominated costs of competitors, regardless of the balance of trade in goods. This has had negative consequences for many U.S. industries, including steel. In effect, high interest rates have hit the steel industry with a triple punch: the industry's own modernization programs have been affected by the high cost of capital; demand for the industry's output has fallen since other industries have also postponed investment and reduced inventories; and exchange rate fluctations have greatly increased the penetration of imports in the domestic steel market causing the domestic industry to lose market share. Moreover, the balance of indirect trade in steel has declined. High interest rate and their effects on exchange rates have caused the trade balances of the steel industry and the steel consuming industries to deteriorate.

COMPARATIVE STEEL COSTS ARE DISTORTED BY PRESENT EXCHANGE RATES

While the consequences of the overvaluation of the dollar are severe they also have the effect of encouraging the view that the domestic industry is uncompetitive. Except for dollar overvaluation, the underlying competitive position of the domestic steel industry is strong—even if markets are weak and the trends in its competitiveness are disturbing. yet this competitiveness is masked by present exchange rates. This is illustrated in Table 1, which shows how costs of U.S. producers versus those of foreign competitors would be altered if exchange rates had maintained the values which prevailed in 1978-1979. This table shows the phenomenal extent to which exchange rate fluctations have altered comparative steel costs—especially in regard in West Germany, France and the U.K. What is our reason for arguing that 1978-79 exchange rates were more "normal" than those prevalent in more recent years? In order to assess the basic competitive standing the U.S. industry at the present time, it is necessary to make some assumption about what represents a "normal" rate of exchange.

TABLE 1.—SECOND QUARTER 1984 PRETAX COST PER NET TON

[At actual operating rates]

	At 2d quarter 1984 exchange rates	At 1978-79 exchange rates average	Percent distortion
United States	478.06	478.06	
Japan	447.66	454.05	1.4
West Germany	416.63	481.54	15.6
France	423.11	645.11	52.5
United Kingdom	397.33	489.52	23.2

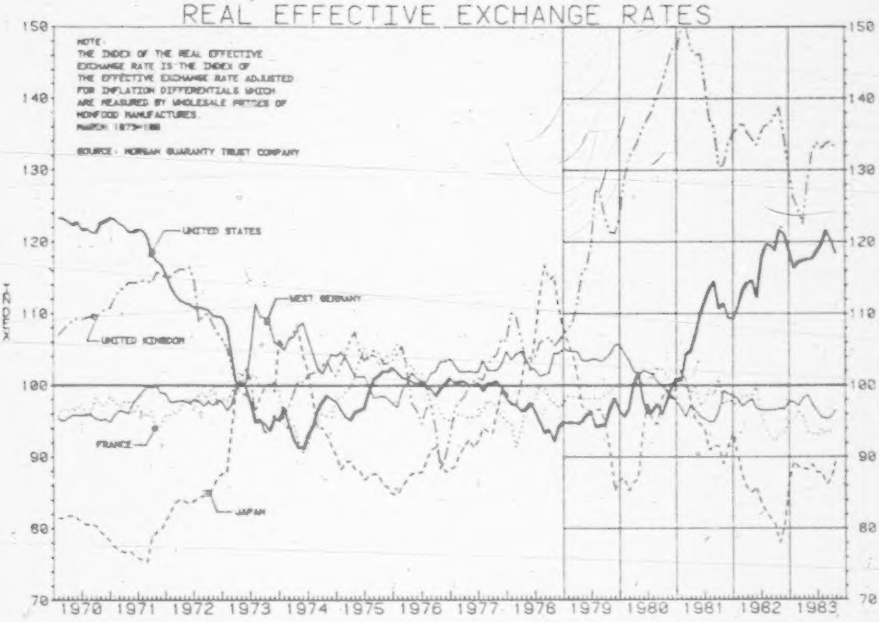
Source: World Steel Dynamics, Steel Strategist, No. 9 February 1984, Paine Webber Mitchell Hutchins, Inc.

At the outset, it is worth recalling that the basic function of exchange rates is to balance trade accounts. Under a flexible exchange rate regime, countries whose trade is consistently and fundamentally imbalanced should have their currency shift accordingly. If they have a surplus (i.e., if the demand for their currency exceeds the supply), the value of their currency should increase. The reverse effect is required if the trade account is in deficit. Thus, exchange rates should not fluctuate widely; they should shift only in response to fundamental structural changes in the world economy.

REAL EFFECTIVE EXCHANGE RATES

To obtain a rational pattern since the second dollar devaluation in 1973, we must look at "real effective exchange rates." Real effective exchange rates refer to the value of a country's currency adjusted for inflation relative to the weighted currency values and inflation adjustment in other manufacturing countries (other currencies are weighted by their share in the international trade of the country concerned). Using this measure, the pattern of international currency relationships becomes surprisingly regular. Using the well known Morgan Guarantee weighted average shown in Figure 1, the exchange rate relationships in effect at the time of the second dollar devaluation (1973) are treated as a base.

Figure 1



As this graph shows, exchange rates for the five countries involved have generally fluctuated consistently around the real values introduced in 1973. The yen has been the most volatile currency throughout the period, but even here there is a high degree of regularity.

The consistency of these relationships began to break down in 1979, when sterling appreciated substantially (due in part to Britain's reserves of petroleum). By 1981, the value of the dollar began a rapid rise, while other major currencies tended to fall. By the early 1980s, the pattern of exchange rates which had developed between 1973 and 1978 had broken down completely.

We can draw several conclusions from the relative constancy of exchange rates from 1973 to 1979. The first is that the outcome of the long-delayed dollar devaluation was positive; that is, the relationships introduced in 1973 did in fact reflect the underlying structure of the world market, as evidenced by the relatively steady pattern of exchange rates thereafter. From 1973 to 1979, real effective exchange rates did operate as they are supposed to, fluctuating to account for transitory shifts in trade balances, but maintaining order in international trade. From the perspective of the preceding six years, thereafter, the exchange rates of 1980 through 1984 to date are in fact misaligned. Recent exchange rate effects on steel costs should therefore be viewed as distorting underlying relationships and not a true measurement of the competitiveness of foreign industries, or of the U.S. industry.

THE U.S. BALANCE OF PAYMENTS—AN ISSUE OF WIDER SIGNIFICANCE

Yet the question still remains of whether the appreciation of the dollar after 1980 represents a realignment towards a new equilibrium—pattern of exchange rates, with a greatly appreciated dollar. This is akin to asking whether the relative strength of the U.S. economy internationally has fundamentally increased.

Last year the U.S. world-wide merchandise trade deficit was about $60 billion. Approximately 10% of that total was due to steel imports. Currently we are running a merchandise trade deficit of about $10 billion monthly, the largest in U.S. history. In the latter half of 1983 the U.S. was running a $10 billion quarterly deficit on current account, again the largest in U.S. history.

The reason that currency values no longer reflect changing trade patterns is that the system has been overwhelmed by capital and short-term money flows that are unrelated to trade. Currency values are now a function of these flows.

EFFECTS ON STEEL INDUSTRY COMPOUNDED BY UNFAIR TRADE PRACTICES

U.S. manufacturers are responding by cutting waste, slimming down, getting more efficient. The steel industry is doing it. But much of the benefits are automatically wiped out by the dollar's upward float.

This is compounded in the steel sector by massive government involvement in foreign steel industries which has distorted the operation of the market mechanism in steel trade. Private producers in the U.S. cannot compete with inefficient, yet subsidized foreign producers, operating from protected home markets and selling at export prices significantly lower than their costs. This problem is especially severe in steel, where government subsidies have generated 150-200 million net tons of excess capacity in the Western world economy outside of the United States. Moreover, excessive government involvement and excess capacity now exists in many developing countries—not just in the EC and Japan.

There has been no definitive response from a succession of Administrations to unfair trade in steel. Accordingly, the American steel industry is now urging the Congress to begin the process of returning some equity to the trade in steel by enacting H.R. 5081, the Fair Trade in Steel Act. This legislation would limit steel imports for five years to the average level which occurred in the 1970s, while we further modernize, a level higher today than that allowed by any other advanced industrial country (including the EC as one trading unit). This would be a moderate response of the U.S., to the unfair trade conditions we have described compounded by major currency misalignments affecting world trade in steel.

[Telegram]

BRAVO LEATHER CORP.,
New York, NY, March 28, 1984.

WAYS AND MEANS TRADE SUBCOMMITTEE,
Longworth Building,
Capitol Hill, DC.

Re 15 percent surcharge on all imports for the period of 150 days. Please be advised that we as importers of raw leather hides strongly object to this contemplated action. It is a firmly held lease that such an action would not only be disastrous to the U.S. import industry and those support industries dependent on same, but would also fuel inflation and cause unemployment by adding to the overhead costs of U.S. manufacturing industries utilizing imported raw materials for their production. We therefore urgently request that this action not be taken.

MARVIN LEVINE, *Director.*

STATEMENT OF PETER T. NELSEN, CHAIRMAN, INTERNATIONAL TRADE COUNCIL

Mr. Chairman, and Members of the Committee. We thank you for the opportunity to present testimony on the United States trade deficit, its causes and our proposed solutions.

We have summarized both and will be glad to submit supporting evidence on each if the committee so wishes.

The causes of the trade deficit are, in part:

(1) An extraordinarily strong dollar causing an inflow of savings from other countries due in part to a high rate of real interest rates;

(2) A weak economic recovery in both the industrialized countries and the LDC's after the recent world recession;

(3) Practically all foreign exchange being earned by the LDC's presently goes to paying interest on debt and on military material;

(4) Political and governmental interference in the free market world economy, causing protectionism with direct and indirect trade barriers.

SOLUTIONS

(1) The exchange rates influence on U.S. international competitiveness should be compensated for by refund to the exporter of the cumulative taxes paid in the various phases of production from raw material to finished product in an amount not to exceed the ratio that existed in a base year such as 1975.

The strong dollar makes it easier for Third World countries to export to the U.S., thus they are in fact getting massive foreign aide through out trade deficit. The industrialized countries will not like the aforementioned suggestion, but they already have similar tax rebates for their own exporters.

(2) The long term solution to the strong dollar problem will be a budget in which federal spending will be reduced from the present 25 to 26%—down one percentum each year until it reaches 20 percentum of GNP.

During the last four decades the inflation rate and the economy has been good when federal spending was at or near 20% of GNP. It was marginal at 22% and bad or worse as it escalated up to its present level. To attain this reduction, we must reduce spending and increase productivity by expanding exports so that better economies of scale are attained. We can thus reduce the budget deficit without substantial tax increases.

(3) Protectionism is always detrimental to consumers interests, and since everyone is a consumer—even the steelworkers and the ladies garment workers—will benefit in the long run by free markets.

There is no U.S. producer or consumer who will use overseas "sourcing" unless the imported product is of a better quality or a better price. Therefore, if the producer needs to purchase overseas to make his product competitive on the world market, he needs the right to do so.

The overseas supplier in turn earns dollars which will enable him to purchase U.S. exports and become a trading partner without the need for "foreign assistance."

We, therefore, urge defeat of the "U.S. content legislation" and any forthcoming variations on that theme, such as import surcharges.

(4) In order to enhance the ability of U.S. producers and of our trading partners to increase productivity, we urge Congress to avoid direct and indirect trade barriers.

(5) Instead of compensation producers for lack of foresight and lack of innovation when an overseas producer sells products that better fit the needs of our consumer, we suggest that those funds be put into retaining workers with obsolete skills.

The Domestic International Sales Corporation (DISC) should be replaced this year with the new Foreign Sales Corporation (FSC) with a provision that FSC's will be able to use the overseas benefits that our overseas competitors have—be it incorporating in a "tax haven" country or tax credit for market expansion with new products or services and into new territories.

The R&D tax credit, scheduled to expire in 1985 should be made permanent now, both on U.S. and overseas source innovation so that producers can plan long term growth now and reinvest in product improvement.

(6) 40% of our markets are presently in Less Developed Countries (LDC's). The major growth potential for the near and long term exists in the same LDC's. We, therefore, urge a renewed effort to encourage and assist private sector development of overseas production units to help those LDC's to become part of the world economy. It is in our geopolitical interest, our humanitarian interest, and our enlightened self-interest to make trading partners of LDC's who now are receiving $12 billion for foreign aid.

We testified before the State Department Commission on Security and Economic Assistance and presented a proposal to establish regional defense pools for the LDC's. A system which would greatly reduce their expenditure for defense material. This will not work everywhere, but in certain regions, it would free up scarce foreign exchange for economic development.

(7) The GATT has been a failure in the quest toward eliminating trade barriers. IDI originally urged the bilateral elimination of trade barriers four years ago—some effort is taking place in that direction notably with Canada and Israel. IDI urges a renewed effort to expand such talks for the benefit of the U.S. producer, consumer and our overseas trading partners.

The eventual depolitization and decontrol of trade is the best hope for a stable world economy—maybe by year 2000.

(8) ITC's last suggestion is a request for the Ways and Means Committee to support with committee report language the currently pending start-up funding of the U.S. International Trade Center (TRADEXPO). We attach a statement of Senator Huddleston which appeared in the Congressional Record last month which describes the project.

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Congressional Record

ADDITIONAL STATEMENTS

A NEW IDEA TO PROMOTE U.S. EXPORTS

● Mr. HUDDLESTON. Mr. President, I would like to call to the attention of my colleagues the new International Development Institute (IDI) and TradExpo, the U.S. International Trade Center, which together, after 7 years of research and design, are scheduled to open by the end of 1984.

The IDI and TradExpo concept form a new and innovative system to increase U.S. exports and overseas development in the private sector. It is particularly designed to help small and medium size companies to enter the export market and to give all American enterprise access to markets in 170 countries with a year round world trade center, educational center and research center.

The health of our economy is a primary concern to the welfare of the American people. If our economic health is to be maintained, we must make progress toward increasing seriously lagging exports from the United States and participating more competitively in the global marketplace.

There appears to be no argument with the assertion that vigorous U.S. exporting is desirable. One out of every eight jobs, says the Commerce Department, depends directly on exports. America's foremost comparative advantage, agricultural products, accounts for $2 out of every $5 worth of our exported goods, and comprises a large and vital part of the American farmer's income. Our exports are also crucial, in financing the purchase of ores and oil, which we cannot produce in the amounts we need. We are firmly locked into export trade as a determinant of our national well-being.

There is further consensus that our exporting income is rapidly spiraling downward. Our share of the world market has fallen from 23 to 14 percent over the past two decades, contributing to the huge trade deficit projected for 1983, topping $69 billion and resulting in 60 percent of the increase in unemployment. American farm exports have declined from a high in fiscal year 1979 of $43.8 to fiscal year 1983's $34.5 billion, a 21-plus percent plunge.

Informed opinion is even confluent about what has caused our waning overseas sales:

A worldwide recession that moderated demand while price supports and other factors kept production high;

A musclebound dollar which overpriced our goods and services in world markets;

Economic advantage taken by other countries, especially in Japan and Europe, by means of protectionist policies, and

The perception elsewhere that the United States is an unreliable supplier, given past policies that attempted to use trade as a political lever.

SOLUTION

Where thinking diverges, however, is in deciding upon a proper course of action to remedy this bad situation, which is growing steadily worse. Recent Federal response has been to provide limited governmental assistance while attempting to create an improved trading climate by subduing inflation, negotiating away protectionist policies, and instituting long-term guarantees that rule out the use of trade as an international nightstick. Beyond that, Federal officials insist that export business should be stimulated primarily through private initiative, and we agree.

In hearing before the House Agriculture Committee in February 1978, Dr. Peter Nelsen, chairman of the International Development Institute and the Agricultural Trade Council, said to those present that America needs improved marketing and production techniques to first balance foreign trade, second, stabilize our farm economy, third, decrease unemployment, and fourth, use our production potential to allay the hunger of the world. These problems are still with us and, despite efforts to solve them, some have grown worse than they were when IDI and TradExpo were proposed 7 years ago. We must awaken to the reality of these problems, understanding that not to decide is, indeed, to decide.

It was from the need for greater foreign sales efficiency that a new approach, operating in the private sector, was developed to meet all the needs of suppliers and buyers in export trade. The system that has been proposed as part of the solution to our shrinking presence in world markets is composed of two complementary, nonprofit corporations: the U.S. International Trade Center (to be called TradExpo) and the International Development Institute (IDI).

HOW TRADEXPO AND IDI FUNCTION

TradExpo and IDI are designed to provide American businesses, which have an unrealized export potential, with an efficient, cost-effective way to reach foreign buyers. While trade centers are not a new idea, teaming a large, central and permanent trade exposition with educational and research services that draw informed customers and encourage interdisciplinary understanding is an innovative step that exceeds the scope of state or regional centers.

TradExpo, a private, nonprofit trading company, and the first to register as such under the Export Trading Company Act of 1982, will provide a direct and accessible link between American sellers and foreign buyers. It is anticipated that the year-round, permanent trade center will, at completion, have facilities in Washington and a nearby rural site for 5,000 businesses to display and demonstrate their goods and services to the 200,000 foreign shoppers who circulate through the capital area annually.

Expert, on-the-spot, up-to-the-minute informational services will be available at TradExpo, expediting the complex legal and financial arrangements that often impede foreign trade. Buyers can, therefore, make their purchases without confusion, delay or further travel. Exhibitors' fees at TradExpo will be modest and should be far more cost-effective than formerly existing means of penetrating foreign markets.

TradExpo will thus successfully address the needs of smaller businesses. These needs were stated, analyzed, and discussed in a 1982 report by the Senate Small Business Committee. As a member of that committee, I helped to initiate and draft this report. The report said that of nearly 1,200 surveyed firms, most said they were reluctant to export chiefly because they lacked the necessary specialized expertise, and/or their limited budgets were strained in meeting the high cost of reaching foreign buyers by traditional means. The report also pointed out that only 200 firms control 80 percent of America's exports, even though "20,000 small firms in this country have the potential to competitively and profitably market their products overseas. Clearly one of the greatest opportunities for reversing the no growth trend in our Nation's exporting lies with tapping that potential and increasing the number of small business exporters." Analysis of the committee's report indicates that TradExpo facilities will help solve or alleviate 87 percent of the problems facing these potential exporters.

IDI, TradExpo's companion corporation, is also designed to meet informational needs of buyers and sellers. IDI is an educational and applied research institute that will form a link between what we learn each year about technological advancement and putting that knowledge to work.

IDI's Education Center will conduct monthly seminars on 12 major categories of technology affecting human needs: fisheries and oceanography, health, education, productivity, energy, forestry, transportation, agriculture, nutrition, communications, water, and housing. These seminars,

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open to TradExpo participants and invited guests from worldwide business, academic and, governmental communities, will keep world leaders abreast of the latest developments in their respective fields and provide a forum for interdisciplinary discussion. The education center will also offer graduate and undergraduate study programs in cooperation with four Washington area universities, multilingual technical training programs, and nuts and bolts courses in exporting.

That such educational endeavors can create a multiplying effect on trade was among the points made by Nelson Denlinger of U.S. Wheat Associates, Inc., in a statement to the House Agricultural Committee this fall. Denlinger said:

> We have found that market educational programs have paid very large long-term dividends to U.S. wheat exports over the years.

Donald V. Earnshaw, Deputy Assistant Secretary of Export Development in the International Trade Administration, said in his testimony before the same committee that his organization had successfully carried out overseas conferences and seminars on the fundamentals of exporting to the great advantage of all participants.

IDI's Applied Research Center will, on request, suggest appropriate technological systems suitable for use in specific locations and test how well technology in place functions. It will keep an extensive data base, assuring that access to the most recent technological improvements is available. Perhaps the center's most important function, however, is carrying out demonstration projects either at IDI facilities or at onsite locations overseas, aimed at developing the infrastructure of Third World countries. These midsized projects could fill the gap between the small Peace Corps development efforts and huge aid projects undertaken by large businesses or governments. They will differ from most previous projects in a greater emphasis on followthrough, rather than carrying out a feasibility study, designing a solution, installing necessary equipment and considering the job finished, IDI's projects will consider technical training, management advice and project evaluation necessary before viewing a project as complete.

TradExpo and IDI will produce a wide range of positive change. Smaller companies will be able to begin selling internationally, and larger businesses can establish or expand existing overseas contacts. Direct transactions will be simplified, more efficient and hence, less costly. Rental of exhibit space at TradExpo is designed to be less expensive than participation in a series of regional trade shows.

Advantages to overseas buyers include the convenience of one-stop, anytime shopping; full comparison and demonstration of products; simplified transactions; and, access to the services of the education and research center.

The system also works toward solution of persistent Federal Government problems. A 10- to 12-percent increase in U.S. exports would reduce the trade deficit by 50 percent, increase GNP by 1.5 percent and provide hundreds of thousands of new jobs. TradExpo will also answer many of the loudly voiced needs of smaller businesses and create corporate and individual tax revenues without huge governmental expenditures. Finally, TradExpo will serve as an export stimulant without necessarily resorting to retaliatory measures in order to counter protectionist policies of many foreign nations.

Private citizens will gain from TradExpo's encouragement of economic growth, reduced necessity for foreign aid programs, diversity of available products resulting from the strength of smaller businesses, and the general stability of the world that follows active trade interdependence.

TRADE AND THE DEVELOPING WORLD

All countries, particularly Third World countries, at present require appropriate technology and services to show them how to best utilize their purchases. TradExpo and IDI can assume a large part of this challenge. If the United States does not satisfy world needs, other countries will reap the consequent benefits. American interest certainly lies in developing infrastructure and in establishing trade relationships with LDC's, resuming a leadership posture there before these huge potential markets become dominated by other, more aggressive nations. As Roger Asendorf of the American Soybean Association told the House Agriculture Committee this fall:

> ASA believes the Federal outlay for overseas market development for agricultural commodities is one of the U.S. Government's best investments in the future prosperity of not only agriculture, but the national as a whole.

In many areas of the world, basic needs are immediate and pressing. The times challenge the humanity of the world, for even though some 800 million people on this planet experience hunger and starvation, agricultural commodities are in surplus in a number of countries. A kink in the circulation of resources leaves some countries impoverished and hungry while others pile up unsold surpluses.

Overseas development projects, such as those available through IDI, will assist countries and people to develop the capacity to earn what they need. They will be able to turn labor to capital, and capital to the necessities of life and further improvement. As the capacity to import is developed in LDC's, the global distribution of agricultural products will improve, thereby reducing the problems of surpluses in producing countries and unmet demand in LDC's.

ACTION

Speaking for the Agricultural Trade Council before the House Agriculture Committee in February 1978, Dr. Nelsen said that if a fraction of expenditures for sudsidies and set-aside programs were spent on market development and the establishment of sound infrastructural bases for trade in LDC's, problems of the farm economy, of unemployment, of the trade deficit and of sluggish GNP growth would diminish. This fall, nearly 6 years and little action later, W. Glenn Tussey of the American Farm Bureau Federation posed the same question to the same committee: "We ask if we would not be further (sic) ahead 5 years from now in world markets if we were to shift a substantial portion of domestic farm expenditures to an effort that would make us truly competitive in world markets?"

Secretary of Agriculture John Block told the same Committee, "* * * the productive capacity of our farmers * * * must be supported * * * by domestic farm programs that facilitate export." Secretary Block offered no program, but insisted, "There must be a better way."

The better way may be through efforts such as TradExpo IDI which have been carefully examined and praised by business and academic leaders, Governors, officials in the executive branch, and Congress. It is an approach that will stimulate the economies of all 50 States, individually and collectively, even as it puts fresh knowledge to use and encourages the shift of developing countries from demeaned recipients of charity to friendly, self-sustaining trading partners. It is in the interests of both U.S. industry and Government to support this kind of innovative program.

Unlike most Government-funded aid programs, TradExpo and IDI will provide ongoing benefits, without the need for continued Government assistance. ■

United States
of America

RACHMAN BAG CO., INC.,
Brooklyn, NY, March 30, 1984.

Mr. JOHN J. SALMON,
Chief Counsel, Ways and Means Trade Subcommittee, House of Representatives, Washington, DC.

DEAR MR. SALMON: I am writing in response to the proposed 15 percent Import Surcharge to counter growing trade deficits. We are importers of towels, and all merchandise that we order is used as supplies for hospitals and nursing homes—in other words, needy institutions with low funds. If these institutions were to purchase domestic goods it would prove to be too costly for their budgets. Should the 15 percent surcharge be put into law, these institutions will be subjected to higher costs on supplies they can currently afford.

With a view toward the under hardship facing such worthy institutions, we feel, therefore that Category 363, at least, should be exempt from the proposed tarriff.

Sincerely,

JEROME M. RACHMAN.

THORNHILL ENTERPRISES, INC.,
Wilmington, DE, March 30, 1984.

JOHN J. SALMON,
Chief Counsel, Ways and Means Committee,
Washington, DC.

DEAR MR. SALMON: Our Company was chartered in January of 1984 to pursue sales of leather goods. We researched the market for over a year and felt we could compete with the established firms. The majority of our goods are imported and our margins are not adequate to absorb the proposed 15% surcharge on imports. Passing this charge on to customers is also not feasible since it will make our goods noncompetitive.

The increase most likely will mean the failure of a well conceived, much researched new business. We urge you to not implement this surcharge. Let free market forces prevail.

Very truly yours,

RALPH D. SCHMIDT,
President.

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